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THE 1989 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

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JANUARY 18 AND 31, FEBRUARY 2, 9, 22, AND 23, 1989

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THE 1989 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, JANUARY 18, 1989

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Scheuer, and McMillan.

Also present: Joseph J. Minarik, executive director; and William Buechner and Dale Jahr, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

This morning the Joint Econimic Committee begins its annual hearings on the 1989 Economic Report of the President and the accompanying report of the Council of Economic Advisers.

We are very pleased to welcome Beryl Sprinkel, Chairman of the Council of Economic Advisers, and Thomas G. Moore, a member of the Council, who will present the findings and recommendations of the 1989 Economic Report of the President, the final report to be issued by President Reagan.

Before turning to today's testimony, I want to express our appreciation to Chairman Sprinkel and his colleagues for the excellent and dedicated job they have done for the Nation during their tenure on the Council of Economic Advisers.

Mr. Sprinkel took over the chairmanship at a time when the Council had been leaderless for almost a year, and there were rumors that it would be abolished. Since then, under Mr. Sprinkel, the Council has regained the great respect it deserves and its proper role as adviser to the President on economic affairs.

Chairman Sprinkel, there are a good many issues we want to chat with you about this morning and to discuss with you. Among them certainly are the administration's economic forecast for 1989 through 1994, which was prepared by the Council.

Another issue will be interpretation of economic history, recent economic history, in the Economic Report of the President.

The 1989 Economic Report of the President generates a thoughtful and reasoned examination of the role of government in the economy, and we will begin our session today with your testimony, and of course members of the committee will have questions for you.

I note that you have another person with you at the table, and you should perhaps begin by introducing that person and describing to us his role.

STATEMENT OF HON. BERYL W. SPRINKEL, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY THOMAS G. MOORE, MEMBER OF THE COUNCIL; AND ALLAN H. MELTZER, A CONSULTANT TO THE COUNCIL

Mr. SPRINKEL. Thank you very much, Chairman Hamilton, Congressman Scheuer. It is a pleasure to appear before you to present the 1989 Economic Report of the President and the Annual Report of the Council of Economic Advisers.

Accompanying me today, on my right, is Thomas G. Moore, a member of the Council, who specializes in microeconomic and regulatory issues, and on my left is Allan H. Meltzer, a consultant to the Council, who has taken over macroeconomic issues at the Council after the departure of member Michael Mussa. He has been gone for about 4 months.

I would like to take this opportunity before I go into the text to thank my staff, most of whom are not with me, who worked long hours during the last several months to help prepare this report.

This morning, I will summarize briefly the content of the report and discuss the administration's economic forecast, as you suggest, and also longer range projections for the years 1989 through 1994. Then Mr. Moore, Mr. Meltzer, and I will be happy to answer your questions about the report or other economic issues of interest.

This report is my last. As I leave, I am particularly pleased to have served the entire 8 years of a successful Presidency that allowed me the opportunity to help test a long-held set of views concerning the proper role of government and how we can best encourage economic performance in the private sector where jobs and income are created.

Although I am not surprised, I am delighted to report that the experiment, from my point of view, was a success or, in the vernacular of my native "Show Me" State of Missouri, it worked.

We are now entering an unprecedented 7th year of peacetime economic expansion. Productivity, after stagnating in the 1970's and early 1980's has increased at rates triple those seen during the 1975 to 1980 expansion. The trend toward higher unemployment and higher inflation that characterized the stagflation of the 1970's and the early 1980's has been reversed. The U.S. unemployment rate fell to the lowest level in 14 years during 1988, while unemployment rates in Western Europe are among the highest, unfortunately, of the postwar era.

The inflation rate has averaged about 3.3 percent in the past 5 years despite the fact that the U.S. unemployment rate has been cut in half. Real family income, which stagnated in the 1970's and early 1980's, has risen 9.4 percent during this expansion. These increases in real income and employment have been widespread, with all major demographic groups sharing in the gains.

These gains were not due to Reagan luck, but rather due to specific policies of President Reagan's administration to reinvigorate the private sector by limiting the growth of government, avoiding the temptation to fine tune the economy, improving private incentives through tax cuts, improving market flexibility through deregulation, resisting protectionism, avoiding new structural rigidities, reducing inflation, and encouraging noninflationary monetary policy.

The report examines the ingredients for good economic performance as well as poor economic performance in the past. We found that the success of the current expansion rests upon an approach that has served the United States well in the past.

The private sector is believed by us to be inherently stable and is the fundamental source of economic growth. Government's appropriate role is to foster the inherent dynamism of the private sector.

It can do so by improving private incentives and providing a framework for economic and political stability, basic public infrastructure, and a social safety net by keeping inflation low and aiming for price stability, and by promoting open and flexible markets.

Free market policies in the four decades following World War II have allowed more people in more nations to increase their standard of living than in any other era in history. In the United States real income per capita and real reproducible wealth per capita more than doubled from 1948 to 1987.

These gains were widespread, with real family income doubling for both those at the highest and those at the lowest fifth of the income distribution. The poverty rate dropped from 30.2 percent in 1950 to 13.5 percent in 1987. Virtually all of the decline was due to rising income, with very little due to the redistribution of income.

The 1980's represent then a continuation, after the stagflation of the 1970's and early 1980's, of this extraordinary period of sustained growth. Lower inflation and lower and more uniform tax rates have improved private incentives and efficiency. The Federal income tax liability of a typical one-earner, four-person family was cut by 36 percent, or by $1,480, over what they would have had to pay under the 1980 tax law. Two-earner families have enjoyed even larger savings of 49 percent. Over 4 million low-income families have been removed from the tax rolls.

And, despite what you may hear, increased spending, not tax cuts, was responsible for the increase in the deficit. I am speaking of the Federal deficit. If tax cuts were responsible, Federal tax receipts as a share of GNP would have been reduced, yet Federal receipts share of GNP has actually increased moderately during this administration.

Progress has been made in reducing the budget deficit. The deficit has declined from 5.4 percent of GNP in fiscal year 1985 to 3.2 percent in fiscal year 1988 and, with adherence to spending discipline, will decline in the budget the President recently sent to you to 1.7 percent of GNP in fiscal 1990, and a balanced budget in 1993.

The report also addresses trade issues and how the strong U.S. economy and employment growth in the 1980's demonstrate that the United States has not been losing jobs.

The trade deficit and the high value of the dollar were the consequences of the relative strength of the U.S. economy. Since 1985, the dollar has come down and U.S. domestic demand has slowed while that of other nations has accelerated as many adopted policies pioneered by this administration. Both the real and nominal trade deficits have fallen sharply from their peaks.

This report attempts to put recent concerns about the trade deficit and foreign ownership in perspective. By the end of 1987, measured net foreign assets in the United States amount to some 3.1 percent of U.S. net wealth on a historical cost basis. However, even this figure may be too high, since the official historical cost estimates underestimate the value of U.S. assets abroad relative to foreign assets in the United States.

As a result, as recently as the second quarter of last year, U.S. earnings on assets abroad exceeded foreign earnings on assets in the United States, suggesting that until very recently the United States was not a net debtor.

The report also discusses how, despite increasing protectionist pressures, we have made progress in the area of free trade with the United States-Canada Trade Agreement and progress in the Uruguay round of the GATT.

This report reviews progress in deregulation, highlighting those areas where important reforms have and are taking place, emphasizing market-based incentives in place of direct control. In the area of science and technology this administration's work to increase funding, improve incentives, and improve the flow of information to the private sector is reviewed.

ECONOMIC PERFORMANCE IN 1988

The past year was another good year for the economy, and we remain optimistic for the future. Despite recession fears following the October 1987 stock market decline, the economy in 1988 recorded substantial growth of real GNP and employment and, despite some temporary upward pressures, a reasonable performance for inflation.

This performance was a tribute not only to the resilience and stability of private markets, but also to policies pursued by the President, the Federal Reserve, and other Federal officials.

At the time of the October decline, action was taken to provide assurances and liquidity to the market and the economy, and the dollar was allowed to adjust flexibly, and after the decline, officials had the wisdom not to rush in and overregulate security markets, but concentrated on increasing supervisory coordination and encouraging broadening of market capacity.

These policies stand in stark contrast to the policies following the 1929 market crash, which preceded the Great Depression. Policies do make a difference.

THE FORECAST FOR 1989

We are now in the 74th month of expansion, and the outlook for 1939 and beyond is for continued growth and moderate inflation. Real GNP is projected to grow 3.5 percent between the fourth quarter of 1988 and the fourth quarter of 1989. Year over year, the increase is estimated to be 3.2 percent.

Excluding adjustments to account for the concluding effects of last year's drought, the economy will grow by our projections 2.8 percent in the current year, fourth quarter to fourth quarter. This represents a downward revision from last summer's real GNP projection, and amounts to a 2.9-percent growth rate year over year.

Our lower real GNP growth rate is in line with the restrained monetary and fiscal policies of 1988. Our assessment of the components of growth shows a continued strong improvement in net exports and above average increases in capital spending but neither at the pace of last year.

Consumer expenditures are expected to increase moderately, lifting somewhat the current low rate of personal saving. Residential investment is projected to rise only modestly; state and local spending will continue along trend and Federal spending is expected to decline slightly following declines last year. Inventory accumulation, partly driven by an expected rebound in farm inventory building, will also contribute to growth in 1989.

Inflation, as measured by the GNP deflator, is anticipated to be 3.7 percent in 1989, fourth quarter to fourth quarter, down slightly from 1988's rate. Food price increases related to the drought and, at the retail level, higher fuel prices for part of the year, added to the overall price index in 1988, and these effects are not expected to be repeated in 1989. The targets for growth of the monetary aggregates remain on a downward trend, and M2 growth has been ratcheted down 1 percentage point for 1989.

MEDIUM-TERM PROJECTIONS

Over the longer run, 1990 through 1994, we anticipate further growth based on trends in underlying factors that will expand the economy's capacity to produce. Real GNP growth is projected to average 3.2 percent annually and inflation is expected to drop half a percent per year.

These projections are contingent on the successful implemention of current and proposed government policies and on the assumption of no significant adverse effects to the economy.

The administration's shortrun forecast and longer run projections are higher than some others, and have been described by some as a rosy scenario. However, I believe the facts do not support this assertion.

Last year's administration forecast was also widely descried as a rosy scenario, but real GNP during 1988 will almost certain turn out to be closer to the administration's forecast than to many private forecasts or forecasts of other government agencies.

In fact, the administration has underestimated real GNP four times since 1981 and overestimated it three times. No rosy bias is evident to me. Much of the original rosy scenario criticism is the result of the administration's 1981 forecasts, which did not foresee the 1981–82 recession. This error was shared by most forecasters. In fact, a consensus of 40 forecasters put real growth slightly higher than the administration's estimate, which turned out to be much too high.

The main difference between the administration's and many other estimates for 1990 and beyond are in real growth and interest rates. The administration's projections assume a return to the roughly 2 percent long-term trend in productivity growth following the poor performance in the 1970's and early 1980's.

Others assume a return to slower productivity growth. Between 1982 and 1987, nonfarm productivity has grown at a 1.9 percent annual rate, more than triple the rate during the 1975 to 1980 expansion, and equal to the rate between 1948 and 1987 and, indeed, the rate over most of this century.

Interest rates and Federal spending are higher in some forecasts than in ours. However, we believe our interest rate projections are consistent with a monetary policy supporting continued growth and continued progress toward price stability. Economic growth does not have to cause higher interest rates. During this expansion, as inflation fell, so did interest rates. It is our expectation that interest rates will continue to follow inflation lower.

The expansion need not end. We are not making the mistake of pushing on the fiscal and monetary policy accelerator just as the economy achieves high employment following successful policies. In fact, we are restraining demand growth by fiscal and monetary policies in order to assure declining inflation and interest rates.

As the economy approaches full use of its current resources, slower growth relative to the rapid pace of recent years is a desired development. Slower domestic demand growth will allow for the continued expansion of the Nation's international sector. Slower overall growth will enable capacity to expand to meet demands in future years and continue the current record-setting expansion.

There are, as always, some risks to this or any other forecast. Our forecast and projections are dependent on the assumption that the basic thrust of policy in this administration will be continued.

In particular, it is assumed that we can avoid higher taxes; increases in mandated benefits that reduce labor market flexibility, or sharply higher minimum wages which destroy jobs, especially for the low skilled, thereby increasing costs and reducing flexibility; re-regulation which will increase costs without commensurate benefits; renewed protectionism—fortunately, the trend has moved toward freer trade with the United States-Canadian Trade Agreement and progress in the Uruguay GATT round—and an excessively tight monetary policy.

Rather, we assume moderate, low-inflationary growth that moves toward the goal of price stability while the Federal Reserve continues to provide sufficient liquidity for real growth.

In summary, we are delighted with the response of the economy to the administration's market-oriented and low-inflation policies. Our policies have brought the longest and largest peacetime expansion in our history, 19 million net, new, good jobs, and rising standards of living for most Americans. A continuation of the thrust of these policies will assure continued prosperity.

Thank you, sir.

Representative HAMILTON. Thank you very much, Mr. Sprinkel. We will follow the 10-minute rule for questions by members.

I want to begin with three areas that stand out in my mind in view of the emphasis you put on market orientation and policies—

the areas of trade, intervention in the exchange rate markets, and industrial policy.

First, with regard to trade, you have a lot of discussion in the Economic Report about trade liberalization, but a number of writers recently have made these statements—and I will quote them to you and I would like to get your reaction to them.

Martin Wolf wrote recently in the Financial Times, "Whatever its rhetoric, the practice of the Reagan administration has been the most protectionist since that of Herbert Hoover."

As I.M. Dessler points out in his book "American Trade Politics: System Under Stress," he stated, "More than one-fourth of U.S. manufactured imports are in products now subject to major quantitative restraint. Import controls on all of these products were initiated or tightened since 1980."

Mr. David Hale, of the Kemper Financial Services, writes approximately the same thing in this month's "the International Economy" when he says, "Ronald Reagan was the most protectionist President in modern American history. He imposed more restrictions on imports than the previous six Presidents combined, pushing the share of total imports subject to quota or official restraint from 12 to 23 percent."

So the first question, then, in view of the President's statement in his Economic Report that protectionism is destructionism, do you agree with these observers that Mr. Reagan, as President, has been quite protectionist in his actions, if not his rhetoric?

Mr. **Sprinkel**. First, I certainly agree with the President's statement that protectionism is indeed destructionism.

I think it is very important to recognize that for whatever reason—and we all have views as to what that reason may be—there have been enormous increases in protectionist pressures, both emanating from some sectors of the American public and reflected in the Congress.

It is indeed true that although we have made significant progress in opening up markets abroad and significant progress in leading the GATT round and the Canadian free trade and, in fact, in vetoing several extreme protectionist bills and making them stick, nonetheless there has been from time to time some backsliding from that point of view.

Frequently, the action was taken in order to avoid even more serious protectionist pressures that might well have developed. We hope that now that employment continues very firm, that the trade deficit on average continues down, that those pressures will abate.

I am hopeful that the new administration can make further progress in opening markets and that the Congress will be cooperative in reducing some of those restraints on imports into the United States.

I think we lose as a result, net, of those kinds of policies, and so does the President, and his statement made it very clear what he believes. He is a practical politician, and you have to do the best you can, and I don't think we have a perfect record on that front. But I think the basic thrust is very clear, and we are hopeful that thrust can be improved in the years ahead.

Representative **Hamilton**. Let me move next to the question of industrial policy. Again, I refer to the President's statement in his

Economic Report, "Governments are notoriously bad at identifying industries of the future, and efforts to have the government formulate and implement industrial policy must be strongly resisted."

I guess industrial policy has received a bad name in recent years, for understandable reasons, yet there are strange things happening. The things that are happening are that the Defense Department seems to be taking on the responsibility for very expensive technology programs whose purposes are as much economic as military.

You have the Semiconductor Manufacturing Technology Program, known as Semitech. You have the High Density TV Program. You have the Superconductor Program. You have the 11-point, I guess, Superconductor Initiative that is aimed at encouraging faster commerical application of superconducting materials. You have subsidies for new research centers, fast track processing of new patents, restrictions on giving information to foreign countries, and the like.

The administration blocked efforts by the Japanese to acquire Fairchild Semiconductor in March 1987.

Now, this has been referred to—these steps and others have been referred to as a defense industrial policy.

How do you put this into your scheme of things? How does the President, when he says, in effect, that "Governments are notoriously bad at identifying industries of the future," isn't that what we are doing in these cases?

Mr. **Sprinkel**. The list that you gave, sir, has some data supporting the question you raise, but others I think are highly desirable. We have put heavy emphasis, for example, on increasing research both in defense as well as in the private sector, encouraging nondefense research, but also heavy emphasis on trying to move the research developed in government labs into the private sector.

You referred to subsidizing this movement, but we have tried to create incentives that would shorten the frustratingly long period of time between the development of a new technical idea and its showing up in the marketplace, serving a need for the American people as well as the rest of the world.

Representative **Hamilton**. Are these steps showing us, Mr. Sprinkel, that the traditional free market policies that we have followed and which you and I have both espoused are not necessarily adequate to meet competitive pressures? Why should the Government be jumping into these things?

Take high denstiy television. Why should the Government be jumping into that?

Mr. **Sprinkel**. I am not certain they should.

Representative **Hamilton**. Why should the Defense Department be jumping into it?

Mr. **Sprinkel**. There have been in the Defense Department—usually under the rubric of national defense, with considerable support in the Congress and in parts of the administration, there have been some actions taken that I think one should watch very carefully and avoid repeating in large numbers, those kinds of actions which bear a close resemblance to an industrial policy. The history suggests we can't pick them very well.

The reason we can't pick them well isn't because we are dumber than the private sector. It is because they can experiment and shut it down if it doesn't work.

Representative **Hamilton**. Why then are we doing it?

Mr. **Sprinkel**. This was the basic view. Whenever you have a policy in an administration, there are debates. Not everyone is on the same side of those debates, but the overwhelming view with Sematech was that this was very important for national defense purposes and that this should be an exception.

I think those exceptions should be very limited. There will be additional proposals, I am quite certain, in the years ahead, and I would hope that the Congress would take a very close look at it because one could easily slip in the back door into a policy that in the long run would not be advantageous to the American economy.

Representative **Hamilton**. I very much agree with your statement, Mr. Sprinkel.

Let me move to one other area, and then I will turn to my colleagues, and that is the whole question of exchange rate intervention.

I recall your appearance before this committee some years ago in which I think your position was that we would intervene in foreign exchange markets only in periods of disorderly markets.

Now, it seems to me that recently the Federal Reserve as well as the European central banks have intervened frequently and even massively.

What are your views about that?

Mr. **Sprinkel**. Your memory of my testimony is correct, sir.

At that time that policy was under my jurisdiction, subject to the Secretary of the Treasury. We looked at a lot of evidence focusing on the question of whether or not sterilized intervention—that is, no change in policy but just intervention—had a lasting effect on the level of exchange rates.

One of the largest studies that looked into that particular issue was as a result of a suggestion we made at the 1982 Versailles summit, where all of the partners in the summit process agreed to make their data available from treasuries and central bankers, and throughout the period when the Bretton Woods system was falling apart and massive intervention occurred.

That study was conducted by the seven governments, and it concluded, as many academic studies have concluded, that such intervention, so long as it was sterilized, did not have a lasting effect on the equilibrium level of exchange rates.

It also concluded that from time to time intervention was justified in order to stabilize a disorderly market.

Representative **Hamilton**. Let met ask you, do you believe that the interventions recently have been for that purpose—intervention becasue of disorderly markets?

Mr. **Sprinkel**. I am not in charge, as I implied, of intervention policy currently. I do not believe that it is primarily for stabilization, but it may be.

Representative **Hamilton**. You mean you don't know why they are intervening?

Mr. **Sprinkel**. I know why they say they are intervening. They intervened to prevent the dollar from coming down. Sometimes they intervene to prevent the dollar from going up.

Representative **Hamilton**. Do you think that is a wise policy?

Mr. **Sprinkel**. No, sir, I do not. I have never believed it is a wise policy.

I do believe it is very important that we work with our major trading partners to try to change policies in a way that will stabilize exchange rates, and as a matter of fact, that proposal was made at that same summit in Versailles, and ever since then there have been regular meetings of the major countries in order to try to coordinate policies in a way that will cause greater stability in exchange rates.

I think considerable progress, not just in the last few years but over the last several, has been made on that front, and I hope it will continue.

I personally believe that the intervention per se with no policy change has a very limited effect and, in essence, tends to shift resources from government to private marketeers, and I do not consider that as a No. 1 objective of government policy.

Representative **Hamilton**. I will turn to my colleague, Congressman McMillan, but let me just give you a quote from the German Finance Minister, Mr. Stoltenberg, who was quoted on January 13 as saying, "At times governments must try to push the dollar's value down, as it did this week, in order to keep the U.S. trade deficit falling. At other times, such as last November, governments should work to keep the dollar from falling too low to avoid inflation within the United States."

Does the U.S. Government agree with the German Finance Minister?

Mr. **Sprinkel**. I don't, and I can't speak for the U.S. Government. I think it is very important that we keep inflation down.

Representative **Hamilton**. Let me ask you, do you agree with the German Finance Minister?

Mr. **Sprinkel**. I do not agree with that particular statement which, if I understand it correctly, he is saying that by intervention and no change in policy we can either push the dollar up or push the dollar down. All the evidence I know about says that is not true.

Representative **Hamilton**. Thank you, Mr. Sprinkel.

Congressman McMillan.

Representative **McMillan**. Thank you, Mr. Chairman.

First, let me congratulate you on your new role as chairman of this committee. You are a good friend, well informed, and highly intelligent, and I look forward to working with you in fulfilling what I believe is your objective and the objective of this committee, and that is providing an educational function for the Congress in addressing the important issues that we face.

And, Mr. Sprinkel, I want to thank you for 8 years of outstanding service to this country and to this administration. I wish you well in whatever you undertake in the future.

Mr. **Sprinkel**. Thank you, sir.

Representative **McMillan**. I would like to come back—I realize this perhaps is an overworked subject, but the national media is preoccupied with the question as to whether or not the proposed budget by the President and presumbably other proposals are based on the so-called rosy scenario.

I realize this is an oversimplification, but could you simply indicate what variations in that scenario might mean, perhaps just for the sake of discussion, what a 1-percent less real growth rate, what a 1-percent variation in the interest rate assumption or in the inflation rate assumption would do in terms of the projected deficit, assuming all other things unless they are directly interrelated remain the same?

Mr. **Sprinkel.** I remember the interest rate number; that is, a 1-percent change in interest rates, will affect costs about $5 billion, $4.5 to $5 billion, in the first year.

I have in front of me——

Representative **McMillan.** That is costs in the Federal budget?

Mr. **Sprinkel.** Yes, sir, because you have to pay interest on the debt, and when interest rates are higher it is going to cost you larger outlays.

I have in front of me, taken from the budget of the U.S. Government on page 325, sensitivity of the budget to economic assumptions, and I will be glad to submit this total sheet for the record.

I believe you spoke of real GNP growth. The effects of 1 percent lower GNP growth in fiscal 1990 would in 1990 reduce receipts, if I am reading this correctly, $6.7 billion, would increase outlays $1.9 billion.

So they are not irrelevant for the total of $8.6 billion.

Let's see what they show here on interest rates. Slightly different numbers.

Representative **McMillan.** It is down there in the middle of the page. I have this in front of me.

Mr. **Sprinkel.** Here they have $4.8 billion. That is about right. That is what I remember; $4.8 billion, 1 percentage point in interest rates.

So it will make some difference, no doubt about it.

I might add that our estimates of growth do not vary much from the CBO estimates if you put them on the same basis.

Our estimate year over year is 3.2 percent growth in real GNP. The CBO estimate is 2.9 percent, and in fact they estimate more revenues with a lower real growth rate than we estimated.

Representative **McMillan.** Do you have a figure that would represent the consensus of informed expert opinion outside of the Government on that subject?

Mr. **Sprinkel.** Yes. I think instead of 2.9 percent year over year, which I referred to as the CBO estimate, and ours is 3.2 percent, the latest report I saw on the average of the blue chip was 2.6 percent, which is a little bit lower even than CBO.

So as I indicated in my testimony, our estimates were a little on the high side, but I think they are justified given the prospects in the period ahead if we don't overdo monetary restraint or settle for higher taxes or sharply higher mandated benefits or sharply higher minimum wages.

I don't know what the Congress will do in those areas. We have to make some assumptions about what they wouldn't do and what they would do.

Representative McMillan. The success of the administration's proposal is based on sustained real growth and coupled with restraint on spending increases, which then has the potential to eliminate the deficit over a reasonable period of time.

This year you pointed out that real growth was 2.9 percent over the prior year—I believe is the correct figure—which generates somewhat in the neighborhood of $80 billion of additional revenue without a tax increase.

Is that a reasonable expectation for the future; that is, the 2.9 percent growth rate equates into $80 billion of additional revenue, or are there factors in this particular year versus last year that made that figure unusually high?

Mr. Sprinkel. No. In the budget that President Reagan recently sent out for fiscal 1990, using the projections that I discussed here, the projection was a little bit stronger but the revenue estimates were a little bit weaker. We estimated an increase in revenues for fiscal 1990 of $84 billion, $83.8 billion I believe.

That, in our opinion—that is without a tax increase—it is enough both to permit some increase in Federal spending, which almost inevitably is going to occur, and also a very substantial reduction in the fiscal deficit, down to $100 billion, which will be 1.7 percent of our real GNP in fiscal 1990, and I think it is doable, and I am hopeful that the Congress and the new administration will agree on that solution in the period ahead.

Representative McMillan. In perhaps oversimplified terms, what you are saying is that revenue expectation, given the projected real growth, will increase Federal revenues somewhat on a magnitude of 7 percent, with an inflation expectation of somwhat in the 4 percent range, which would enable the Federal budget to expand with the rate of inflation and still leave us with annual surplus enough to reduce the deficit in line with the Gramm-Rudman targets?

Mr. Sprinkel. Yes, sir, that is correct. I hear lots of complaints about cutting spending, but we aren't cutting spending and Congress hasn't been in the business of cutting total spending. There has been a slowdown in rates of rise, and that is what will be necessary in the period ahead if we are to meet the Gramm-Rudman targets, and I think we will meet them one way or another.

Representative McMillan. Medium range, just to carry this a little further. The long-range forecast is based upon an assumption of sustained real growth, perhaps lower than we have experienced over the last 5 years but nevertheless a healthy, perhaps not rosy, real growth rate, containment of inflation and decline in the interest rates, but it is also based upon sustaining the impressive productivity gains that we have experienced on a magnitude of 2 percent.

Mr. Sprinkel. Yes, sir.

Representative McMillan. What do you consider to be the major factors contributing to the capacity of the United States to sustain that rate of productivity improvement?

Mr. Sprinkel. We spent several pages in this report reviewing some of the evidence on that front as to why has productivity improved. You can't be absolutely certain, but you try to associate it with things that you would expect to improve it as well as things in the past that have caused it to decline.

One of the important developments that I think can continue to help us in the future is getting inflation and inflation expectations down because managers are less concered about taking advantage of the inflation and are more concerned about running their shop in a way that gets output up versus the input, therefore getting productivity up.

We have also argued that continued growth in international trade has been a contribution to force some of our companies, painfully sometimes, to adjust their situation in a way to get their costs under better control so they can maintain their markets.

We think deregulation has helped. We are not in favor of eliminating all regulations, but we do think that we can do a better job at cost and benefit analysis on the regulations that we had, and we pushed hard in reducing some of those, and maintaining high levels of capital investment is also very important.

We are running very close over the last 6 years to productivity gains that equal the long-term trend, which you have mentioned, about 2 percent. We have averaged 1.9 percent for total.

Manufacturing has done much better, and that is a part of the total, obviously. Manufacturing productivity has been increasing during this economic expansion at an annual rate of about 4.3 percent, which is far above the postwar average and enormously above the 1970's.

So that I think continuation of the basic trends that we now see in place will probably permit us to enjoy productivity something near 2 percent.

That is one of the major differences that becomes evident when you compare what I consider to be moderate projections of a little over 3 percent a year with other projections which assume that productivity is going to drift back toward the 1 percent range instead of the 2 percent, where it has been for about 6 years.

So I am pretty comfortable with our estimate of about 2 percent productivity growth and about 3 percent or a little better growth in real GNP.

As you pointed out, sir, that is less than we have grown during this economic expansion, but you have to remember that during that expansion we were pulling the unemployment rate downward, both in terms of unemployment of people as well as underutilization of capital resources.

None of us know for sure what full employment is, but we know we are a lot closer now than we were at the trough of the recession in 1982. That meant that you can take advantage of underutilized resources as well as growth factors.

Looking into the future, there is not much room to reduce underutilization of resources, perhaps a little, but we have to rely on the longer term trends, and I think it is therefore reasonable to expect that we are going to drop from the 4.2 or 4.3 percent rate of growth down toward 3 percent, and 3.2 percent is a reasonable number from our point of view.

But that is rather good. That has been our long-term goal, incidentally, over the last century, something around 3 percent on average.

Representative **McMillan**. My time has expired, but the comments raise two other points that might be worthy of examination at another time.

It seems to me that while we have pulled the unemployment rate down dramatically we have also—and there are a lot of fundamental changes taking place in this economy and in the global economy—but we have been able to respond to a very profound social change in the United States at the same time. And I don't have the figures to back it up, but we have absorbed many more people into the defined work force.

Two working spouses, for example, in many families didn't exist 10 years ago, 20 years ago. We have not only been able to sustain ourselves in a global economy, but we have been able to respond to the very profound social change domestically, which I think is highly significant.

The other is the issue of measuring productivity in an economy that is increasingly moving into outputs that are more difficult to measure. It is easy to measure the output of tons of paper or yards of cloth, but with dramatic growth in services, whether it be, say, medical services or legal services, or you name it, it is very complex measuring productivity. Yet that is where our economy is increasingly placing new resources, and I think that is something that perhaps this committee could address at a later date.

Mr. **Sprinkel**. I agree with you, sir, on both of those comments. We have the highest percentage of our population working today above 16 years of age, and excluding those confined in institutions, in the history of the country. It just continues to gradually move up. I think it is 62.6 percent now, including all the retirees. That is highly favorable.

I think one of the reasons for that continuing growth is the incentives that have been provided with getting those marginal tax rates down. There are some other laws that I think inhibit individuals staying in the work force longer.

Now that I am getting in that age bracket, I am especially interested in why it is that a lot of people quit. I am not going to quit, regardless of the rules that are in those laws, because I enjoy work.

But I think there are a lot of people that drop out that, if given the right kind of incentive, would stay in. That is the kind of people that we need to draw on for skills they have developed over a lifetime.

With respect to measuring productivity, you are certainly correct. It is conceptually difficult to measure productivity in services, as you indicate, because it is very difficult to distinguish between quantity change and price and quality change.

For example, if you look in the financial area, an area I used to know fairly well—I know less well now after spending 8 years in Washington—the numbers show that productivity in finance has gone down. I don't believe that for a minute. I go into my old bank, and I talk to people in the business, but that is what the numbers show.

And it isn't just finance. That happens to be one of the most egregious. I don't believe that has happened.

But I am not criticizing anyone, other than to say I think efforts by this committee to try to help the researchers do a better job of estimating productivity improvement in services would be well worthwhile. It is happening, but we don't know it is happening. That is the difficulty.

Representative McMILLAN. Thank you, Mr. Sprinkel. My time has expired. I wish you well, and I am glad to hear that you are not going to drop out.

Mr. SPRINKEL. I can't afford it after 8 years in Washington. That is the reason. [Laughter.]

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Thank you very much, Mr. Chairman.

Mr. Chairman, I want to express my pleasure at your acceding to the chairmanship of this committee. You have always been a very thoughtful, very professional, very insightful member, and I look forward to working under your leadership.

I also want to express my pleasure at being joined by my colleague, Congressman McMillan. He has been a very diligent, contributing member, whose views are always interesting and thoughtful. On a committee where members are pulled and tugged from all parts of the compass and sometimes find it difficult to attend the hearings, you have been a very contributing and excellent member, and I look forward to working with you in the 101st Congress.

Mr. Sprinkel, you have appeared as a witness before this committee many times. You have always been thoughtful. You have always been provocative.

We have enjoyed exchanging views, perhaps making debating points. I am going to try not to do that today. In the last 2 days of this administration it seems a little futile to be trying to score any debating points.

Let me congratulate you on one great contribution you have made to this report, and that is your identifying your area of education as an area of our economy where we have underspent and where the challenge now is to improve our educational system up to meet the needs of the individual, meet the needs of our business community, and make us a dynamic and productive society.

From my vantage point this seems to be a sharp departure from past policy statements, and I welcome it and I congratulate you. I had rather not engage in a lot of niggledy-piggledy questioning on why did you come to this revelation so late. When in the last 8 years have you proposed increasing expenditures on education?

As you know, Mr. Sprinkel, Federal aid to education has been cut. If the Congress had agreed to all of the cuts that the administration had requested, we would have reduced Federal aid to education in real dollars over the last 8 years about 36 percent.

Now, we haven't done that, and I am glad we didn't do that, and I am glad right now that, as I say, in the last 2 days of an administration that went on for about 2,920 days, that you are stating very firmly and unequivocally in this report that we have an education deficit and we ought to get on with doing something about it.

I think you have performed a very major and constructive achievement in doing that. I don't know if it will cause you any discomfiture, but we welcome it. [Laughter.]

I do want to correct just one matter. As I say, I am not going to engage in trying to score debating points, but you do say in your statement, "Free market policies for the four decades following

World War II have allowed more people in more nations to increase their standard of living than in any other era in history."

Now, to a significant extent that is true, and there is no doubt in my mind whatsoever that free market policies around the world have proven themselves. Forgetting about the dialectic, forgetting about the debating points, there isn't a socialist economic model anywhere in the world that has worked.

Free market economies, free enterprise, free flow of capital, and free competition have been the model that has worked. On an empirical, hands-on, pragmatic basis, you can't come to any other conclusion. The socialist economic models have been a bloody disaster.

And if you want to look to free enterprise models that worked, all you have to do is look to Japan, Taiwan, Singapore, Hong Kong, South Korea, and Malaysia now, and you will see how they have worked.

So I am all with you on that. But free market policies have their problems, too.

In a recent report by UNICEF, just in the last month or two, Jim Grant, the American director of UNICEF, states that for several years the impact of developing world debt on those economies has caused them to contract expenditures on social services, on education, on health, on job training and that this has caused a per capita income decline, personal income, all over the developing world.

I am not talking about Japan as developing world countries. I am talking mostly about Africa and Latin America. There has been a decline in per capita living standards there caused by the pressure on their governments by the IMF, the World Bank, and so forth, to get their houses in order.

Unfortunately, that has resulted in a widespread pattern of cutting the very social services that could make their countries productive. It seems that as they cut expenditures in education and health that that has caused an increase in the rate of population. That has encouraged the population explosion.

As you know, education of women and employing women, opening the job market to women, is the greatest contraceptive going. When women understand the potential for self-expression that they can achieve through education and access to the job market, they tend to want to restrict their families.

So the experience of the last few years has been that when you cut education expenditures and when you cut efforts to bring women into the job market they do what they were trained to do for thousands of years, and that is produce more babies, and that has had a devastating effect on per capita incomes of the developing world.

That is about the only subject in this interesting report of yours that I wish to take issue with.

Do you have any comment on that? Do you have any guidance for the new administration on what they can do in terms of a more enlightened and thoughtful and creative management of Third World debt that would enable Third World countries to spend more, not less on education, on health, on job training?

Mr. **Sprinkel**. Let me make a couple of responses to your question. Then I would like to pass the ball, if I may, to Mr. Meltzer, who also has a great interest in this subject.

First, I think it is fair to say that the adverse trend in economic performance in many of the developing nations that you cited, especially in Latin America and Africa, is not inconsistent with the prior observation you made that capitalist societies do well and socialist societies don't. There is nothing inconsistent there.

The problem, there have been a few countries in Latin America and a few in Africa that have followed more market-oriented policies and they have done better. Chile is one where economic performance—until recently you could say there was little hope for democracy, but even that is changing—their economic performance has been outstanding and they have relied very heavily on market forces to organize.

Unfortunately, many of the other countries may start out in a way to improve the flexibility of the market and to cut the fiscal deficits and get he money supplies under control, but then, because of political or other forces, they change their policies.

Now, we have not resolved the debt problem. We do have some discussion in that report about further actions that we think might help, and they have to do not with devices for World Bank guarantees or Federal Government guarantees, but devices which will encourage greater and freer negotiation between the debtors and the grantors.

One of the two, if not both, made the mistake of creating excessive debt. Even though I spent most of my life in banking, I do not buy the idea that we, the American taxpayer, ought to bail both the debtors and creditors out from their mistakes.

Representative **Scheuer**. I totally agree with you, and there was greed and irresponsibility both on the part of American lending institutions and on the parts of the elites who incurred those enormous debts, mostly to their own benefit, in these developing countries, and it is only a sad irony that the elites didn't suffer. It is the people who have suffered, as I have just indicated to you, as a result of the pressure they have been put under and as a result of the pressure these governments have been put under by these totally ill-conceived loans which never should have been made, and I think the American banking community and the elites of the Third World together who placed those loans on the backs of their people are equally to blame and are equally guilty.

Mr. **Sprinkel**. There's lots of blame to go around. The point is what do we do now?

We believe that encouraging direct negotiation between the borrowers and the lenders to resolve this issue in a way that can be mutually beneficial is the right way to go. Some progress has been made, but I think further progress could be made, and I would like to ask Mr. Meltzer——

Representative **Scheuer**. Mr. Sprinkel, my time is limited. I think that you have given us a very good response to that. If we have extra time, I would be glad to hear from Mr. Meltzer, but right now I would like to go on and say some very nice things about you.

Mr. **Meltzer**. I wouldn't want to get in the way of that. [Laughter.]

Representative **Scheuer**. I really think you have made a great contribution by sounding the clarion, as you have, on the need for enhanced investment—not spending but enhanced investments, as you clearly stated—in education.

On page 84 of the report, you say, "The decline in Federal nondefense investment could reduce future living standards. Future administrations should consider expanding programs of nondefense investment, including investment in infrastructure and education, to improve future productivity."

Now, I want to congratulate you again for having said that as forthrightly as you have.

You also sound the alarms at the plummeting outlays for capital investment in research and development because a fall in investment adversely affects the inputs into the private sector.

Very constructive, both of them.

As I mentioned, the Federal investment in education has been going down. It would have gone down a lot further if Congress hadn't dug its heels in. It would have gone down 36 percent.

Did you ever suggest that this was an unwise policy and that we had a very dangerous education deficit as well as a trade deficit as well as a budget deficit and this education deficit was going to come back and haunt our productivity? Did you advise the President as his chief economic adviser over the past 8 years that this was a dangerous and intellectually flawed policy?

Mr. **Sprinkel**. I have participated and so have my staff in numerous policy discussions concerning the education thrust of this administration. We recognized that most expenditure on education is not the Federal Government; it is mostly State and local.

I served 8 years once on a high school board, and it happened to be that had very high standards in mind for their students and was selected, even though we organized it from scratch, as one of the outstanding high schools in the country.

So most of it has to be from the parents and not from the Federal Government.

Representative **Scheuer**. No question about it.

Mr. **Sprinkel**. But within those constraints, we have pushed very hard to have greater freedom of choice. Many, especially the underprivileged, are locked into a particular school, which may not be a good school, and they have no alternative. The rich people can send their kids to private schools, but the poor are locked in.

And we have urged that some of the aids that are being given be given in the form that will give them choice, and I am hopeful the new administration and the Congress will continue in that.

Representative **Scheuer**. Let me build on that. You make a very important point.

Some parents have been able to take advantage of private school eduation to the benefit of their kids. Now, the Head Start Program has been really the diadem in the crown of the Poverty Program.

I was fortunate enough to have been a Head Start kid myself. Now, you might want to ask why, since the program really didn't get going until 1965.

Mr. **Sprinkel**. That is what I was wondering about. [Laughter.]

Representative SCHEUER. Head Start really has enriched preschool education. OK, I went to nursery school in 1923, and it was essentially a Head Start experience.

You may say, well, in your, case, Congressman, you couldn't prove much by the results of that. [Laughter.]

But the fact is for almost a hundred years middle-class parents and well-to-do parents have been providing a Head Start education for their kids, and it has catapulted middle-class kids into educational success.

The Poverty Program, the Head Start component of the Poverty Program, has worked outstandingly well, and in a recent hearing that I had, that I chaired, with the Joint Economic Committee's Subcommittee on Education and Health, we had literally several days of hearings and dozens of testimonies from outstanding American business leaders, let alone educators, testifying to the importance of making Head Start available to every single young child in need, making it an entitlement for kids in need as a key to their educational success.

They make the point that when kids drop out they don't drop out in the 10th, 11th, and 12th grade; they really drop out in the first and second grade, when they are unable to compete with their competitors from middle-class homes, homes that are education factories. They drop out when they find that they can't learn to read, write, and count. The actual leaving school may happen years later, but that is when it happens.

There is total unanimity that we ought to make Head Start available to every young American child an educational need.

Would you subscribe to that theory?

Mr. SPRINKEL. I would want to see the costs. I have seen some of the evidence indicating that the Head Start programs, among all the programs that were attempted, have one of the best records, certainly in the shorter run. I would like to see some data, I would say, 10 to 15 years later, but I suspect it is still in place. I am not sure.

Representative SCHEUER. We all know the costs of not providing, of not preparing kids for that first day of school, and you have indicated very well that education must be a high priority and that we should look upon expenditures in education as investments in our human capital.

Mr. SPRINKEL. That is what it is.

Representative SCHEUER. I couldn't have stated it better, and not simply outlays, not simply costs that we incur.

Mr. SPRINKEL. If I might add, I perhaps benefited from Head Start under the same definition that you used. I attended 8 years of one-room schoolhouses, and it was frowned upon and eliminated after I graduated, but the advantage was that you could learn from older people because they were reciting in the same room.

Now, I see the educators are beginning to take a somewhat more favorable view of that kind of education.

Representative SCHEUER. Give us some advice here.

We have a man who says he is going to be an education President, and I believe George Bush. I like him and I respect him. I have served with him in this House. He is a splendid human being.

He is going to be a first-class President. He wants to be the education President.

As you know, Congress puts educational reform and educational improvement—given the skills and the learning and the talents that are necessary to make our labor force a productive, skilled, and competitive labor force, we put that right at the top of the agenda.

Would you have any advice in the last couple of days of this administration, both to the new President and to the 101st Congress, on how we best can perform and improve the quality of our educational system and, as a result, improve the quality of our work force and of our future citizens? How do we go about it? What do we do?

Mr. **Sprinkel**. I would go back to the earlier comment I made.

Please give these people freedom of choice so you can encourage competition at the local school system. I mean, if you get a group of educators that want to do it their way and it turns out not to be the best way, the parents have no options. If you pay them, if you create the ability for them to move to a different school system, you will get the benefits of competition that both you and I believe are important.

It will work in education just like it works in the production of widgets.

So that is the one most important statement I would make. I wouldn't argue that the more we spend at the Federal level, the more successful we are likely to be. That will fade off pretty quickly.

But I am very strong on the importance of maintaining high levels of investment in people. That is as important as fiscal investment, and I am quite confident that the new President will indeed take a hard look at that whole area and even the prior Secretary of Education will be on his Cabinet and remind him of some of the progress that has been made in these past several years.

Representative **Scheuer**. I had intended to close down, but I need one last little question on this whole subset of questions.

Would you deny that the Federal Government has a legitimate role in enhancing education effectiveness and some expenditures may be appropriate?

Mr. **Sprinkel**. Yes, sir. I have never denied that. I have benefited from the GI bill, and to say that I am against it would be rather foolish.

Representative **Scheuer**. Let me just footnote that statement, of course, by saying that we for the first time have done a cost-benefit analysis of the GI bill by one of our very talented staff professionals, William Buechner.

He did that just a couple of months ago in preparation for this hearing on whether we should extend the public education system 2 years down to include Head Start and some years up, perhaps 2, 3, or 4 years of postsecondary education.

His study indicated that there was a cost-benefit algorithm per dollar of funds spent on GI bill of something like $7 to $12 in return. It is the most spectacular cost-benefit investment the United States has ever made to my knowledge.

If we considered investment in seat belts, which is $1 spent to $2 recovered, very good. Anything over 1.5 is good.

This was 7 to 1, somewhere between 7 to 1 and 12 to 1, depending on the circumstances.

So I applaud your view of the GI bill of rights. I am a GI bill of rights kid as well as a Head Start kid, and I think you indicated you were, too.

I think you have made a real contribution by emphasizing the importance of improving our education system, of sharpening the Federal role and stimulating education improvement, and I thank you for your testimony.

Mr. **Sprinkel**. Thank you, sir.

Representative **Scheuer**. I thank the chairman for his indulgence.

Representative **Hamilton**. We will begin a second round of questioning.

Mr. Sprinkel, I want to ask you about your interest rate projections and your economic assumptions.

Now, you project very good economic growth, 3.5 percent in 1989, 3.4 percent in 1990, and a decline in Treasury bill interest rates, 6.3 percent in 1989 and 5.5 percent in 1990.

Recently, the Federal Reserve has been increasing interest rates even though real growth in recent months has actually been lower than the growth which you project for 1989.

What makes you think, then, that the Federal Reserve will reduce interest rates if the economy grows as rapidly as you are predicting that it will grow in 1989?

It seems to me you have interest rates declining in a strong economy when normally interest rates would be expected to rise, wouldn't they?

Mr. **Sprinkel**. Well, we have had a strong economy, as you know, sir, for the last 6-plus years, and interest rates during most of that time have trended downward, not always.

Just as important as the rate of growth is also the rate of inflation.

We believe that the modest kickup in inflation this year—and we believe it was time to happen—was temporary, reflecting two short-run factors; namely, the drought, which temporarily pushed food prices up at a higher pace and was a real cost to the American economy and to the farmers, but that has receded.

The other, of course, was the weakness in the dollar evident up until about a year ago, and that fed through in terms of higher prices for imported products and the low-energy bubble during part of that period.

We think those temporary factors are receding.

The Federal Reserve this past year hit its targets, lo and behold, something very useful to behold, which you seldom see, and they hit them somewhere near the center of the targets as a matter of fact, and those targets have been gradually brought down.

All of that spells, to me—and it is just that, not certainty—that inflation is going to continue to recede as it has and will continue to do more. If we stick to those policies, it certainly will.

We know that lower levels of inflation get lower levels of interest rates. That doesn't mean each and every month. It is indeed true that over the past few months, especially during the period when the Fed was tightening some, interest rates rose.

In fact, the short-term rates are approximately 2 percentage points above the average that we projected for this total year, and I believe that the rate of rise in economic activity remains milder—there is no sign of a surge, I am not aware of one—and that the inflationary pressures are waning and that it is reasonable to expect in the months ahead in this year that we can see some decline in rates.

Representative **Hamilton**. You are aware, of course, that this particular aspect of your projections is the most jumped on, if you would?

Mr. **Sprinkel**. Yes, sir, and I think that is the weakest part.

Looking at it today, if you had to say where is the forecast most weak, I think I would say the interest rate projections.

We adjusted upward. We released that report on November 22, but we did most of the work September to October, and we adjusted upward for what had happened, but then following the upward move that we used in our estimates the rates rose quite a bit, about 200 basis points.

Representative **Hamilton**. I can't help but observe, Mr. Sprinkel, that the private sector, which you generally credit for being better than government in most respects, has interest rate projections that are higher than yours.

Mr. **Sprinkel**. Yes. I think that is right.

Representative **Hamilton**. Now let me ask you for a moment about Federal Reserve policy, monetary policy.

The Federal Reserve frequently made changes in monetary policy in response to changes in the economy. When the economy showed signs of slowing in 1985, the Fed loosened monetary policy and brought interest rates down. In 1987 they tightened policy. Interest rates rose until the October stock market crash. Then the Fed pumped in a lot of money.

Since the spring of 1988 the Federal Reserve has tightened, and interest rates are going up again. This is what you criticize in your report. It seems to me it is, at any rate, a stop-and-go policy.

Do you think the Fed has made appropriate changes in monetary policy in these last 3 years in response to the changing needs of the economy?

Mr. **Sprinkel**. I think the batting average is pretty good. That is, on average over the last 3 years they have gradually ratcheted monetary growth downward. I think that is appropriate.

I believe, as I am sure many others believe, in 1987 they were overdoing the restraint and helped contribute to the decline in the market. But to their credit, shortly thereafter, as you indicated, sir, they put money into the system but they didn't let it explode. And starting in the spring they moved it downward.

If you look at what the pattern has been on average—1985, 1986, 1987, and 1988—it seems to me over the past 3 years we are making some progress toward the kind of monetary policy that can give us stability and growth at lower levels of inflation.

I do not like to see frequent finetuning efforts, as your question implied, either in monetary policy or the fiscal policy area, or that policy either.

It is not really a philosophical difference, it's just that the lags are so difficult and so long that nobody is smart enough to do that very effectively and very often. Therefore, I would like to see more stability in monetary growth. And we are doing pretty well this year.

Representative **Hamilton**. Do you have the feeling that the Fed is aiming for 2.5 percent growth rate?

Mr. **Sprinkel**. That was, if I remember correctly, the average forecast of the Board members when they were sampled by the chairman as to what they expect to have in the year ahead. I think you would have a hard time saying that everybody on the Board believes that 2.5 percent is the right growth rate.

Personally, I believe that the Federal Reserve can do very little to affect the supply side of the economy.

I am constantly pleased, and sometimes amazed, at how effective we have been at creating jobs—not we; I am talking about the marketplace. We shouldn't be worried about that. What we should be worried about is gradually slowing demand growth. That is what the Fed has been doing.

Representative **Hamilton**. Is the appropriate way to do that pushing interest rates up?

Mr. **Sprinkel**. The appropriate way to do that—it may lead to short-term interest rate increases in the short run—but the appropriate way to do it, in my opinion, is to gradually reduce the growth in the monetary aggregates. And that is what they have done.

Representative **Hamilton**. So, you are in accord with and supportive of this Federal Reserve policy over the past few years and you still are today, as they seek to push interest rates up and slow growth; is that correct?

Mr. **Sprinkel**. I do not believe they are trying to slow real growth. If they are, I am not in agreement with that policy.

What I would like to see them do——

Representative **Hamilton**. Why are they pushing interest rates up if they don't want to slow growth?

Mr. **Sprinkel**. They want to slow growth in demand, I am hopeful. And so do I. That is, I would like to see us get back to price stability.

You say, well, it's not possible. But I can remember the 1950's.

Representative **Hamilton**. I don't understand something. Isn't the thing that is motivating the Fed now to push interest rates up is that they are trying to slow growth? Isn't that what they're trying to do?

Mr. **Sprinkel**. I think you should ask the chairman that question. But I suspect——

Representative **Hamilton**. But you are a pretty keen observer.

Mr. **Sprinkel**. I speak with him a lot. I know the Federal Reserve people quite well. I am sure there are some either presidents of Fed Banks or maybe even some members on the Board that have in mind they want to slow real growth. I don't think that is the basic thrust and views of most of the Federal Reserve Board members.

The more growth you get, the less inflation you get. And we shouldn't be in the business of trying to slow growth.

Representative **Hamilton**. I want to be clear about it. I just was kind of surprised to hear you say that because I must say that I have been operating on the assumption that that is what the Fed has been about here the last few months, that they have been concerned about the economy overheating, getting too much growth, they have been concerned about inflation, and they have said we have to push interest rates up in order to slow things down a little bit.

Mr. **Sprinkel**. I think they have been attempting to slow demand growth. And that is indeed what they should be trying to do.

But I do not believe that they should be focused on slowing real growth. I mean, that is the supply side of the economy, and it is working very well. Jobs are being created each and every month.

I think, as I indicated in my testimony, we have the capacity to grow around 3 percent or so and that we should welcome that growth but make sure that we don't get demand grow so rapidly that it comes at the price of a very high-inflation rate. That is what we want to avoid.

Representative **Hamilton**. Before going to Congressman McMillan, let me take up one other topic, and that is these new figures that came out this morning on the trade statistics. I know you are familiar with them, but perhaps others are not.

They show a deficit of $12.5 billion, which is a $2.2 billion increase over the October level. The deficit is the net result of exports of $27.2 billion, which is about the average for the last 6 months, and imports of $39.7 billion, which is not far from the average of the preceding months.

I would just like to have your comments about these trade figures and see if you see any improvement in them or any firm sign that we are going to get that trade deficit down.

Mr. **Sprinkel**. Well, as we argued in the report, and I certainly believe, we think further progress in this year at least in this year and perhaps longer, in the trade deficit is very likely.

That doesn't mean each and every month—as you know, the series tends to be rather volatile, less volatile than it was, because they are now seasonally adjusting it. Not very well, but they are seasonally adjusting it. Therefore, it bounces around.

This particular month we happened to get two adverse bounces: one on the imports, which went up a little and one on the exports, which went down.

But I think it's very important to keep perspective. If you look over the last 11, 12 months, we have had the trade deficit come down 22 percent. That is significant. Exports are up 27 percent. Imports are up only 8.7 percent. I think that trend is still in place, but you can't prove it with the most recent release which showed a deterioration in the trade deficit and slightly more than the market anticipated.

But the dollar was off at the very beginning, and when I left the office, it has snapped back to where it was before the numbers were released. So, it wasn't a lot worse than the market anticipated.

Representative **Hamilton**. Congressman McMillan.

Representative **McMillan**. Let me shift to something that is somewhat related to that, I think, the trade deficit and the level of interest rates. That has to do with the concerns that have been repeatedly expressed about the U.S. dependence upon foreign capital, or becoming a debtor nation, which suggests dependency.

There are a lot of positive reasons why that exists. For example, our trading partners who enjoy that $140 billion a year trade surplus with the United States have, it seems, an interest in funding it.

Then, they begin to pull the props out from under that, which may begin to pull the props out from under the favorable trade position, which may have economic benefits to it, despite what they say.

The other has to do with the very positive attitude toward investment in the United States, not simply debt but equity.

I heard last week when the managers of one of the major international equity investment operations that has very flexibly shifted its investment policy over the past 40 years, was heavily invested in Japan, now for the first time has 65 percent of its equity investments in the United States and is continuing to do that because they basically have confidence in the American economy.

Once they invest it here, it goes through the plant and equipment and so forth, and they can't just take it home. It creates jobs, it creates growth in the United States and creates productivity and so forth.

Would you comment a little bit, particularly with respect to the influence it may have on interest rates, about some of the risks that you see in the present situation with respect to the flow of foreign capital into the United States?

Mr. SPRINKEL. I fully share the observations you made, that we don't go out and lasso that foreign capital. And it is free to leave whenever it chooses.

What happens is that foreign investors recognize the superior performance of the U.S. economy vis-a-vis most of the rest of the world. They want to invest here and they have been investing here.

They own slightly over 3 percent of our total assets, which is not very much. They are not about to own us. We own ourselves, but they have a little piece, 3 percent, 3.1 percent, I believe.

Furthermore, I frequently hear that we are the largest debtor in the world. And of course, that is a gross distortion of reality. My best guess is that we didn't become at all until early last year. In fact, as I indicated in my testimony, up until the second quarter of last year, payments to us from investments made abroad exceeded payments by us to foreigners for investments made here. That includes both debt and equity.

Since that time, there is a slight amount more payment abroad than coming in to us, which suggests to me that we have become a slight net debtor. But the important thing is what do we do with those funds that come in here. Are we on a big consumer binge, which will make us feel good in the short run, certainly, but won't do much for our long-term growth, or have we been using those funds to maintain a relatively high level of investment?

I think it is primarily the latter. So, it is not something, in my opinion, that should cause us to try to knee-jerk solution like putting on controls on capital inflows of preventing or trying to use protectionism to slow the rise in imports into the United States.

I think the markets are adjusting. Foreigners like investing here. That is the way we came from scratch initially. Foreigners built this country along with hard work by the citizens and savings by the citizens. That continues to be the case.

The prospects of the United States, in my opinion, have never been better if we manage our affairs correctly. I don't blame foreigners for wanting a piece of the action, but we benefit from it and we shouldn't try to drive it away.

So, I feel rather relaxed. Yes, I would like to see that trade deficit gradually come down a little more, but primarily for political, not economic reasons.

I have the great concern that when you see a sharply higher trade deficit, that protectionist pressures build and we are likely to take very foolish actions that will reduce our standard of living considerably.

Therefore, if we can keep some further improvement, as I think we can, in the year ahead in our trade deficit, this will imply a somewhat slower rate of importation of capital. But we will continue to benefit from the capital that has come here in the past as well as the new capital that is coming in.

So, I am not as uptight as some people I read concerning either our net debt, which is minuscule internationally, or that foreigners are owning America. They don't own America. They have about 3 percent of it. And furthermore, that we are creating jobs and income and growth with the capital that is coming in.

Representative McMILLAN. Just following on, do you see the present situation deteriorating to a degree where it could have an impact on U.S. interest rates that would upset some of the forecasts that are behind your presentation?

Mr. SPRINKEL. No, sir, I do not. I do not see why it will cause the Fed to get a lot tighter, which could push interest rates up. I don't see why it's going to lead to inflation which could push interest rates up.

And in fact, some argue that the availability of funds coming in from abroad has kept interest rates from going up as much as they might have otherwise. You can't be sure about that.

But I do not see any threat on the interest rate front, if that was your question.

Representative McMILLAN. I think I have a little more time. Let me introduce another subject, and I am sure we won't have a chance to fully explore it: the S&L crisis.

We will be receiving from the administration suggested solutions. The magnitude of the problem has been defined all over the lot and seems to grow with every redefinition, perhaps somewhere in the neighborhood of $75 to $100 billion.

If we cured the problem today—I don't want to get into the nature of the cure—but on the assumption that it is there, would you care to comment on the economic effects?

The reason for this question, since those losses have already occurred, have we not already suffered the economic impact of the problems of the industry and what we're talking about now is who basically is going to pay for it and how are we going to account for it rather than any future economic negative impact—assuming that we solve the problem; that is, stem the ongoing losses, shut down the failed and losing thrifts.

Mr. **SPRINKEL**. I agree that the economic effects have occurred, and there has to be someone pay. I wouldn't want to stop there, however. It seems to me extremely important that when Congress and the new administration work on this problem—and it is indeed a serious one—that we should make certain, if at all possible, that there is major reform in the industry so that we don't end up doing this again in 5 years.

The incentives aren't working right. There is the broad question: Is there any longer a justification for that kind of an institution? I don't want to presume yes or no at the moment, but in many respects, it probably ought to be a bank, not a savings and loan, and maybe we need the same kinds of rules.

We certainly need higher capital standards so that when the institution is deciding on what kind of an asset to acquire, they are usually—in their mind, not our mind, and they are not taxpayer money—but because of the fact that they have guaranteed deposits.

We certainly need to worry about the question of why does every institution pay the same amount for its insurance. You have risky institutions, you have very high-quality institutions. They all have to pay the same rate. That does not lead to the right kind of response.

So, the main point that I want to make is that, yes, it's a serious problem and something must be done about it, but let's not just concentrate on dollars—you have to do that—concentrate on reform in the industry because that will make a lot of difference as to whether we have to do it again in 5 to 10 years. And no one wants to do it again.

And we spent, I think, three pages in this 260-some-odd-page report on that particular industry, and I am sorry that that received most of the attention in some of the papers. It's not the only thing we discussed.

Representative **MCMILLAN**. Thank you very much. My time is expired.

Representative **HAMILTON**. Congressman Scheuer.

Representative **SCHEUER**. Thank you very much, Mr. Chairman.

Mr. Sprinkel, you have sort of minimized the importance of our trade deficit and indicated that the budget deficit was comparatively minuscule compared to if you look at the funds going out in the service of the deficit and the funds coming in for the service of the deficit.

It's true it has only been in the last year or two that we have become a deficit nation. But it is also true that our gross debt has grown from less than $1 trillion—the accumulated debt of 200 years. As of 1980 it was less than $1 trillion. Now it is about $2.6 trillion or $2.7 trillion. That is an exponential increase in a matter of only 8 years.

And it seems to me that we ought to think about that, too, because we were an overwhelmingly creditor nation up until about 18 months or 2 years ago. And that is a significant change. And that comes from a fundamental fact that we are on a spending binge. It was the first one of those two alternatives that you posited to us.

And we are. We are purchasing, we are spending about $140 billion or $150 billion a year more than we are producing.

That comes through the grace and tolerance of Japan, West Germany, and a few other countries that are producing approximately $140 billion more than they are spending, and they are giving that to us or lending that to us. And they are taking our paper. They are taking our credit. They are taking our T-bills.

Doesn't it seem to you that we have to right this fundamental alignment, we have to correct it, and we have to do something to stanch the flow of this consumer spending binge in cars and consumer electronics and all the rest and we have to increase—and you point this out—our investments in research and development, new plant and equipment, and so forth, so that we can increase our productivity and we can become competitive again?

What Government policies would you recommend to stanch the flow of consumer spending on products that are produced abroad—cars, consumer electronics, and without trade barriers?

I agree with you that simple protectionism would be a knee-jerk and not very relevant reaction. How do we get the American people to get off this spending kick and to begin to save? The Japanese save 18 to 19 percent of incomes. We save 2 or 3 or 4 percent.

How do we get our people to save at the same rate as people in other industrialized countries, including the big dragon and the four minidragons? How do we channel that into new plant and equipment and research and development where investment is plummeting, as you point out in your report and where you expressed a legitimate concern?

Can you sketch the broadly based national policies that would change us from an overwhelmingly consuming country into an investing country, a country that is investing in its productivity, investing in its future, investing in research and development for new products, new technologies, and investing in new plant and equipment to give us the wherewithal, the economic and productivity muscle to compete more effectively in world trade than we have been doing in the last decade or so?

Mr. **Sprinkel**. That is a tough question, and it is an important question, and I don't want to allege that I know all the answers.

Clearly, one important act that I think will happen one way or another is gradually getting the fiscal deficit down to zero and doing it mostly or, hopefully, exclusively through spending restraint, not cutting spending—you're not going to cut spending—but slowing further the rate of growth. That would be a major contribution.

I personally am very pleased on the whole with the compromise reached between the Congress and the administration on the tax reform bill, and I don't want to be interpreted as saying that it was a bad bill. I think it was a good bill and a lot better than what we had before.

There are still some things that weren't done. If you're focusing on how can you encourage savings you might want to take a look at the capital gains rate. The vice president has indicated that he wants to take a look at it. I realize that in order to get the compromise at one stage of the game, it was necessary to agree to a higher capital gain rate. Therefore, I was willing to pay the price even though I didn't like it.

But now you're asking a different question: How can we encourage investment, how can we encourage greater savings? The beauty of looking at that capital gains tax and cutting it is that you may not even lose revenues. You probably won't. And you certainly will encourage entrepreneurship, savings, investing. I would think that would be useful.

We also have not reduced the incentive for debt creation to the extent that some of us would like to see. We have a tax system which encourages debt and consumers can deduct. They are supposed to have lost that right, but then you put in the special provision: If they get a loan under some kind of a housing arrangement, then they can deduct it. That is not exactly something that encourages savings and investment. So, I think that there are some changes that we could hope to make.

I also am rather optimistic that we have seen the trough in personal savings. The population is getting older. Even my kids who are interested in consuming, consuming, consuming, are beginning to worry about saving, saving, saving. They have kids they have to worry about educating. And as we get older, on average, the savings rate goes up.

So, I think we will see some of that. That doesn't mean that we shouldn't also directly address the issue, and I think there are some things that the Congress and the administration working together could do to gradually improve our savings rate over time further than it has done in the past, certainly.

Representative SCHEUER. Turning to another question, Mr. Sprinkel, your budget report holds that the rapid growth of Federal Medicare and Medicaid costs has been caused in large part because inflation in health care has rapidly outpaced the overall rate of inflation in the American economy. Of course, you're absolutely correct. Health care costs are going up at about twice the rate of inflation of the CPI.

The Subcommittee on Education and Health just finished 9 days of hearings on what we can do to get a handle on health care costs. And I am going to give you a couple of points that the witnesses made. We are in the process of writing a report. They had three or four things they recommended. Then I am going to ask you if you have any suggestions as to how we can get a handle on health care costs.

Joe Califano, the former Secretary of HEW, and Uwe Rinehardt, a professor at Princeton, both testified that the health care system was a chaotic one—duplication, overlap, gaps, and so forth—and that through sheer hardheaded reorganization and streamlining of the system, we could save about $125 billion a year, about a fifth, 20 to 25 percent of all health care costs.

They recommended a couple of things that we ought to do. Mostly they involved research which would have an enormous payoff.

First of all, they recommended research into what works and what doesn't work in our health care system. And they indicated that perhaps 20 to 25 percent of all our treatments, our operations, our drugs, our tests, our processes don't work, don't contribute anything to the health and well-being of the patient. They are wasted, and sometimes they cause actual harm.

Mr. **Sprinkel.** They don't want to be sued, though. They have lots of incentives.

Representative **Scheuer.** That's correct. You have laid your finger on a great problem: the whole question of malpractice. That is certainly part of the answer.

But they felt that even when it came to operations, tests, and medicine and so forth, maybe a quarter of them simply didn't work and cost a lot of money. You're talking about tens of billions of dollars.

The third thing they emphasized is that small amounts of research into three or four things that cause the immobilization of the elderly either at home or in nursing homes could save tens of billions of dollars in long-term care.

They specifically mentioned small amounts of research—and I am talking about a couple of hundred million dollars—in arthritis, in senility, in incontinence, in the causes of falls, would reap exponential benefits. Each one of these might cost a couple of hundred million dollars in research but would save tens of billions of dollars a year in the cost of long-term care for the elderly.

These are just three or four of the things that they mentioned.

Also, making public to people information that had been gathered under due process about doctors and hospitals that threaten your health rather than enhance your health, so that people have knowledge of the hospitals that have two or three times the rate of nosocomial infections—that is, infections you get in the hospitals—two or three times the rate of medical error, or iatrogenesis, as they call it.

If they had knowledge of which doctors had been in charge in hospital after hospital after hospital, which doctors had a string of Medicaid judgments against them as long as your arm, which doctors had been delicensed in State after State after State, that people would exercise some judgment and stay away from these high-risk health care providers and go with the ones that had attractive records of helping people at low risk.

These are some of their suggestions. Do you of your own knowledge have any suggestions to make to us as to maybe these ways or other ways in which we can get a handle on these galloping health care costs that, as you say, are going up at about twice the rate of inflation?

Mr. **Sprinkel.** It is an extremely serious problem, and I look forward to reading your report.

But I would like, if you will take the time to let my associate, Tom Moore, who has done much more work in the field than I, respond briefly to that highly technical but important problem that we are all facing.

Mr. **Moore.** Let me suggest two other possible steps that might be taken. The first is that we need a system of medical insurance that does not encourage first-dollar coverage. We have too much first-dollar coverage, which is very expensive for what we get. We encourage people to go often for symptoms that are very minor because they need company. Some elderly people visit their doctors simply because it is something to do. And this runs up the expense.

We need coverage for major medical expenses, but let people pay for going if they need to have their hand bandaged because they cut it.

So, we need to reduce that. The tax system now encourages too much first-dollar coverage.

Representative SCHEUER. Mr. Moore, I want you to continue, but I do want to react to that.

One of the points that I didn't mention was that they thought that we ought to change the focus of our health care system—from sickness care, illness care in very expensive hospitals, and open-heart surgery and transplants and things like that—we ought to change that focus to preventive health care, to the very elderly people that you are talking about.

If an elderly person has to pay $25 to $50 for a visit when they have a cold and they don't do it and they don't get that preventive health care and counseling, they may end up in a hospital with pneumonia or some other very serious disease.

You are quite right that people, especially elderly people, do access the health care system for purposes of socialization sometimes. The tough thing is how do you right a health care system that is open to that elderly person that legitimately needs advice, needs counsel, needs important preventive care from preventing a common cold or something else which if untreated would develop into a major medical expense involving thousands or tens of thousands of dollars?

You have made a legitimate point, but if you restructure the system so that it is expensive to get that first preventive care visit, then you are going to let yourselves in for a lot of serious problems that you wouldn't have had if that person could have received the care.

And I emphasize that we ought to have a reimbursement system that compensates doctors and nurses for counseling people, for advising them on how to enhance their health.

As a matter of fact, they were saying that the best single expenditure that we could make to reduce galloping health care costs and increase the cost effectiveness of health care expenditures for elderly people would be to teach elderly people what we already know about what they can do to improve their health.

So, the consensus was that counseling and preventive care was terribly important, and we were underspending in that area. You have made a perfectly legitimate point: how do you access, how do you create a system that has access for people who need legitimate counseling and legitimate preventive care and treatment, and how do you cut out of it, if it's possible, with a surgeon's scalpel those who are only accessing the system for purposes of socialization?

And you are quite right, that is a factor. You are caught between Scylla and Charybdis, between a rock and a hard place. I don't know the answer to that. Maybe you can shed some light on it.

Mr. MOORE. I can't give you a simple answer either. I think you have a very good point. It is important to get serious illnesses early. I am bit more skeptical than some of your other witnesses are on general uses of preventive medicine. The studies I have seen on, say, general physical exams indicate that they probably are not very effective in detecting illnesses and so on. But I don't want to get into that.

You have a real point there. The point I was making, there is a lot of waste going on because of the first-dollar coverage.

The second point that I want to make is—that is a general one—I think if we could introduce more competition, more voucher schemes, for example, let people go out and purchase their own insurance and purchase their own medical program with a voucher scheme where they can then supplement that and so on if they want a better scheme and introduce some competition because I think competitive pressures are the only things that are going to keep these medical expenses down.

So, we need to get more competition, give the people vouchers to purchase the insurance and then let them use it for whatever system meets their needs best. That will get the best system at the lowest possible cost.

Representative SCHEUER. You raised an excellent point, Mr. Moore.

And I think my time is approaching its termination if it isn't already over, but I want to make one last point.

We have health maintenance organizations that do provide first-dollar costs, but it seems to me very much more cost effective than the fee-for-service system. Under the health maintenance organizations, as you know, you pay a stipend and that takes care of your health care for the year.

They do, therefore, access the system for preventive health care and, I have no doubt, for some socialization too. But the costs have been really well controlled in the HMO's even though they do cover first-dollar expenditures.

Is the problem the first-dollar costs that we are now covering, or is the problem the way we compensate doctors and nurses and health institutions? Is the fee-for-service model the problem, or is it the fact that we pay first dollar?

It seems when you have a preventive care system like HMO's that people are trying to access for preventive health care, then it's pretty effective. Is it the system by which we compensate the health care professionals, fee for services against the health maintenance organization; or is it the fact of covering first-dollar care?

Mr. MOORE. I don't think it's the fee-for-service system. I think people should have the choice. If they want an HMO, that's fine. If they want to go to a fee-for-service system, that's also fine. I believe—and I don't have a great deal of experience or knowledge about the HMO's—I have an impression that the HMO's used typically ways to discourage casual socialization use of the system.

Representative SCHEUER. They do, I believe so, for the very reasons you pointed out.

Mr. MOORE. Which for some people leads to impressions of degraded service as opposed to the fee-for-service system. So, people have the right to choose from both.

My point is simply that if you have a tax system that provides incentives for providing first-dollar coverage, that is providing the wrong incentives and helping to push up costs. Therefore, what we should do is move to some tax system with tax provisions that do not encourage that.

People, if they want to buy—I believe firmly in people's freedom to buy whatever medical services they want—but let's not encourage this first-dollar coverage.

Representative SCHEUER. Thank you very much.

Representative HAMILTON. Mr. Sprinkel, I want to see if it is possible to submit questions to you or are you at the point that you are so close to the end that you cannot respond?

Mr. SPRINKEL. I am leaving tomorrow. It's pretty close. [Laughter.] But if I could get them fairly promptly, I would do my best to dictate an answer before I pull out tomorrow evening.

Representative HAMILTON. I may want to submit three.

Let me cover a couple of things rather quickly. I have been reading in the paper about an East-West economic conference, and I am just puzzled by that. What is the significance of the conference. Why did we agree to that? We are sitting down with the Soviets to talk about economic problems under the CSCE arrangement. What is the significance of that?

Mr. SPRINKEL. I guess I am not aware of an agreement to have an East-West conference, an economic conference. I am aware that Treasury had, when I was there and still has, meetings with the Chinese each year. They come here, we go there.

Representative HAMILTON. Let me interrupt here. Secretary Shultz announced last week that the United States has agreed to participate in an East-West conference on trade and financial matters in Bonn. And it will involve 35 nations of the CSCE and the Soviet Union.

I will not push you any further.

Mr. SPRINKEL. I don't know. I haven't talked to Secretary Shultz.

Representative HAMILTON. I am very curious about it because it represents to me quite a switch, and I don't understand the reason.

Let me go on to a couple of other things quickly.

I was intrigued with a sentence in the report with regard to Third World debt in which you wrote—and I will just quote the sentence—"A longrun solution to the debt problem must be directed to regenerating investment opportunity within these countries. Short-term solutions must include either reschedulings or other types of negotiated adjustment."

And it is the words "negotiated adjustment" that I was interested in.

Would that mean, for example, that any type of agreement that is voluntarily negotiated between the creditor and the debtor, reduced interest rates, or writeoff of the principle would be acceptable?

Mr. SPRINKEL. That was the kind of thrust that we were suggesting in the report. Now, I don't want to argue that Treasury will immediately buy on to that idea. They may or they may not.

But it seems to us that it is very clear that that debt is not worth a dollar for a dollar. It is probably going at 50 cents, 30 cents, 40 cents. I don't know what; it varies with the country. And under the right kind of an arrangement, where a voluntary agreement is reached between both the lender and the borrower, and not necessarily by the IMF but directly by the borrowers and the lenders, it seems to me it's in our interest nationally to promote this as much as we can.

It should be in the bank's interests to clean up their books over time, and I would hope in the debtor countries' interests to get some advantage of the fact that the value of that debt has declined. So, experiments along this line, I think, would be desirable.

Representative **Hamilton**. Concerning 1992, I want to ask you whether or not the Council or other areas of the Government are now undertaking detailed studies of the possible impact of European integration. Are those studies underway in the Government?

Mr. **Sprinkel**. Yes. We have had meetings on it. I am sure there will be many more in the coming months.

Our major interest up to now, and I think it will probably continue to be our major interest, is not to block that development. We are supporting the development, and we think they will benefit and we indirectly will benefit as well as directly. But to make certain that it doesn't become a protective wall around the EEC, making it difficult for the rest of the world to get in, including us.

So, I am sure through our work in Brussels and the various agencies in Europe, that has been our basic thrust and I think it will continue to be.

Now, many of the leaders of Western Europe fully agree with that point of view. For example, Prime Minister Thatcher has made it very explicit that she doen't want to be a part to setting up protective devices to keep the rest of the world out of Europe.

So, we are not without allies on that front. And I think we must continue to work hard. I agree fully with the thrust of your question.

Representative **Hamilton**. Jumping to another topic, the JEC has had an interest in the quality of economic statistics for some time, and I know you have. We picked up some criticisms of those statistics from the American Economics Association and the National Association of Business Economists.

I am just interested in getting your general impression at this point. How do you feel about the quality of economic statistics that you deal with? Are you pleased with them? Do you think there is a need for mammoth improvement or a modest improvement? What is your general stance?

Mr. **Sprinkel**. Well, I suspect that we have the best statistical system in the world. But it's far from perfect. We were talking this morning about how big a net debtor is the United States. The fact is none of us knows for sure. We can look at various ways of looking at it and get a clue, but that data isn't very good. We have long had troubles with inventory data.

I think our employment data is fairly good, except you have two surveys that in any one particular month may be quite different. Now, over the period of a year, they will usually smooth out and you will arrive at the same conclusion. But it makes it a little confusing trying to tell the President, for example, whether it improved or deteriorated when one is going one way and one is going the other.

The productivity numbers, I suspect, may be among the weakest, especially in the service area. And you brought this up earlier. I hope we can put some of the best minds to work on that and see if we can't get the data quite a bit better.

Representative **Hamilton**. Is this something the Council concerns itself with? Do you push the Government to get better quality data?

Mr. **Sprinkel**. We have in some cases, although that has not been—perhaps it should have been—a major effort.

We did work very hard, for example, to get these trade data available in a way that was seasonally adjusted, that you could have some comparability over time. And there have been a few other cases. But we have not been especially active in trying to improve the quality.

But I think there should be some more resources devoted to that issue in the future.

Representative **Hamilton**. We will try to wrap up here because we have had you here a long time, and we appreciate very much your testimony.

I have been working pretty hard at asking questions that Mr. Meltzer would have to answer, but I haven't succeeded in that yet.

Mr. **Sprinkel**. Could he expand a little on your debt issue? I suggested that earlier.

I would appreciate if you would, Mr. Meltzer.

Mr. **Meltzer**. Thank you.

There are several things I would like to add to what Mr. Sprinkel said, although I think the general points have come out.

The principal issue here is the use of resources in those countries and what we can get those countries to do so that they will have an incentive to use their resources better and use the money they borrowed better.

One of the suggestions we have in the report is to try to move the incentives for both the creditors and the debtors in the direction that would be in the interest of all of us; for example, to remove the role of the IMF and the World Bank as interest collectors, principally, where the responsibility for making sure that the interest is paid falls primarily on the international agencies and is a condition of their loan.

We would perhaps think that it would be useful if the conditions of those loans should be tied most directly to the reforms. The incentive that that wouldn't make—the incentive change that that would make would be that the country receiving the funds would not see that it was using most of those funds to pay interest back to banks in the United States but would see that the interest that was paid was tied directly to the performance that they make in reducing their inflation in privatizing some of their assets in whatever conditions there would be internationally.

Representative **McMillan**. These funds would be funds from the international——

Mr. **Meltzer**. Very much as they are now. As you know, over the years the international agencies have taken on more of the lending and the banks have withdrawn.

Now, that has had some very fortunate effects, weakening the balance sheets of the international institutions, increasing the amount of debt relative to equity, relative to exports, making things more difficult in many ways over the longer term for those countries but giving them the very limited incentives to make the reforms which are ultimately the one condition which will make for an improvement in standards of living in those countries.

It will not be what we do in the nature of what we lend them, it will be what they do with the resources and how they use them.

So, one step would be to tie the condition or to make the loans, the new loans, conditional on the reforms. And as Mr. Sprinkel suggested, to give the debtors and the creditors greater responsibility—indeed, I would say full responsibility—for working out what kinds of arrangements they want to make on a country-by-country and very much on a voluntary basis, as under the present system, working out the values of those previous loans.

The effect would be that if the international agencies are removed from the problem or have a smaller hand in the negotiation of the values of the old debt, the banks might have a greater incentive to think about that question. The countries would see themselves as paying a smaller tax, in effect, for reform, because more of the money would be going into reform. So, they would have great incentive and they might have to share the value of those debts. At least there would be some movement in that direction. I think that is very important.

Another issue which we discussed in the report and which I will discuss very briefly is we think that there needs to be a rethinking of the role of the international agencies—I alluded to part of that—and how they are going to function in a world in which there are no longer fixed-exchange rates.

We have the World Bank, which was primarily a project lender and it is now moving over into doing things that the International Monetary Fund used to do. I don't think it is in the interest of the United States and certainly not in the interest of the lending community to have those two agencies performing the same function. And providing the opportunity for some interplay between them that would lead to a reduction in the credit standards of one or the other or both of those agencies.

Representative **Hamilton**. Do you want the World Bank to guarantee some of the bonds that might have to be issued?

Mr. **Meltzer**. No. I would like to see the private creditors and debtors work out the values of those debts. The market knows what the value of the debt is. And most of the losses—very much like your own question about the savings-and-loan associations—most of those markets have recognized that the value of the debt is lower than it is. It is now a matter of finding out how we can work out those solutions.

And there has been some remarkable progress. Chile is an example of a country that has worked its way almost to the point where it is back into the marketplace. South Korea, which was not one of the major 15, has done extremely well in working down its debt.

Now, there is room for a great deal more. Mexico has made some promising, sometimes hesitant, but very promising steps in the direction of reform. So, there is much that could be done, and that work has redounded to the benefit of Mexico.

Representative **Hamilton**. I thank you for your comments. They have been helpful.

Let me jump around a bit and ask one more quick question of Mr. Sprinkel.

When you talked with Congressman McMillan about the S&L crisis, it raised a question in my mind. Do you think we need to lower deposit insurance?

Mr. SPRINKEL. As you know, in that three pages we devoted, one of the points that we made was that a contributing factor to the difficulty was the very substantial increase in the size of deposits that very substantial increase in the size of deposits that were insured. I believe it was $40,000 up until 1980, and then it suddenly jumped to $100,000. The purpose of the insurance in the first place was to prevent bank runs, and it did that pretty well.

But when you raise it to very large amounts, it makes it possible for poor managers to attract a lot of money because the Federal Government is going to bail them out to the tune of $100,000.

Furthermore, some of those that got into trouble were bailed out even if they had more than $100,000. And also, even the financiers of the holding company were bailed out in the case of some institutions.

So, I know that politically it is probably very difficult to ever pull back from something once you have granted it. But at least we should understand that if we are going to have that kind of system, that at $100,000 per deposit, that we have to have other incentive systems within the institutional arrangements that will make sure that the managers make prudent investment decisions.

So, politically, I think it is probably a no starter, but it ought to be explored as to whether or not it makes any sense to gradually over time pull out a little bit and therefore force me and you and others who deposit money in banks to ask the question, "Is this the kind of institution I want to put my money in?"

If it's a good, well-run institution, the answer could be yes. If it isn't, we shouldn't encourage those deposits with very high insurance. So, I have some concerns about it, but I am not very hopeful that is the direction we will go. If you keep it at $100,000, you should at least change some other incentives.

Representative HAMILTON. OK.

Congressman McMillan.

Representative MCMILLAN. Thank you, Mr. Chairman.

Just a couple of quick followup questions.

We were talking about the accuracy of economic data, also expressing our concerns about the low-savings rates in the United States in contrast to others.

I don't know what is a desirable savings rate. Perhaps it varies with time and depends upon what the savings are needed for. Are they needed for financial security over time? Are they needed for investment in equipment and jobs? That varies.

But I do want to ask a question: Do you believe that our measure of the savings rate in this country is accurate? Does it include, for example, contributions to pension funds, annuities, cash value on life insurance, the surplus in the Social Security trust fund, just to name a few?

Mr. SPRINKEL. The ones I believe you mentioned are included or attempt to get included in some measures.

But there are other kinds of activity that do not. For example, if you save and spend money going to school, human capital expenditures on education are not included as investment and savings.

Perhaps my biggest period of savings was when I was in graduate school, living, I guess, in abject poverty, though I didn't realize it, building the possibility of a higher income stream later. We don't measure that. Other countries don't either, but we tend to put a lot of expenditures on education vis-a-vis the rest of the world, even though the results aren't as good as we would like. Therefore, it tends to distort our numbers relatively.

Also, we count purchases of durable good, automobiles and various other durable goods as consumption and yet we save and invest and use those services over a considerable period of time. And you say, well, so do other people, using financial income accounting, do it the same way, except we tend to have a very high level of expenditures because of the high standard of living in this country on durable goods. And therefore, it also tends to distort our numbers.

There have been studies—and I would be glad to give you the names or have it sent up if you would like—that try to adjust for the inadequate ways in which savings and investment are measured and those studies have concluded that the United States is about like the average nation.

We are not a spendthrift nation. We do maintain reasonably high levels of savings. That doesn't say we shouldn't do more or less, because you are right, I don't know what the ideal savings rate is but I think the official data understates. That is what I am saying.

Mr. MELTZER. May I just add one thing to that, Congressman McMillan?

The question is usually directed to the personal savings rate, which most often gets reported, and it does include many of the things that you mentioned. Mr. Sprinkel's answer is in terms of the gross savings rate, which is one which would be more comparable to gross benefits.

Representative McMILLAN. One other quick question.

Mr. Moore, you stated that our tax structure provided an incentive to incur first-dollar medical care costs. Did I understand you correctly?

Mr. MOORE. That's correct.

Representative McMILLAN. Is that because of the deductibility of those expenses through, typically, company group plans?

Mr. MOORE. That's right.

Representative McMILLAN. There may be some things that could be done to, let's say, raise the deductibles so that it doesn't provide that incentive. But it seems to me a major distortion exists in our health care system when we are faced out there with 30 percent of the population that does not have insurance.

Is the fact that for the average guy on the street, his medical care costs are not deductible unless it reaches catastrophic proportions, nor are his medical premiums deductible unless he passes the threshold of, for many, catastrophic proportions?

It seems to me that one of the ways to address the question of the uninsured is to equalize that tax deductibility. Even if you had a deductible threshold, it would not encourage casual use of the benefit. That would then get a tax incentive into the system to encourage people who have their own insurance—which maybe is a subject for an inquiry by Congressman Scheuer's subcommittee.

But I just wanted to clarify your comment on that, specifically what you were referring to.

Mr. MOORE. It does seem to me that it might make sense to look at—and again, we are opening up the Tax Code which just had a major reform and I am reluctant to suggest that we do it—but we should look at the question about individuals being able to deduct insurance.

But if we do do that, I think it should be only for catastrophic health coverage with a high deductible, as you say, and then the same kind of deductibility should be provided for corporations as well, limit coverage deductibility only for those major policies that cover major medical problems and not first dollars. Do it across the board for everybody.

Representative MCMILLAN. Thank you.

Thank you, Mr. Chairman.

Representative HAMILTON. We will conclude with a question from Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Mr. Sprinkel, you mentioned in your budget report that the production of chloroflurocarbons, the so-called CFC's, is limited by international agreement, the Montreal agreement that was signed, as you recall, last fall.

You point out this will result in higher prices and potential windfall profits to remaining producers. And the budget report goes on to recommend that the Government should charge market value for CFC production rights, which would raise $400 million in 1990.

Since that Montreal protocol was negotiated a year and a quarter ago, the Du Pont Corp., which sells about $60 million a year of CFC's, has come out and said that its continuing research has indicated that we should stop completely, totally, production anywhere in the world of CFC's.

The Montreal agreement reduced the production of CFC's from the present level by one-half by the year 2000. And the Du Pont Corp., in what I consider an act of great statesmanship, said our continuing research has evaluated the problem of the hole in the ozone, has evaluated global warming, the "greenhouse effect," and we come to the conclusion that we must stop production of CFC's—period—anywhere on the globe.

Now, this is a tough calculus. We are talking about potential fees. The Government is going to charge the market value for the CFC production rights, raise $400 million in 1 year, against the statement of an organization that is profit oriented and not a googoo bunch of "tree-huggers" [laughter] as the Cabinet Secretary in this last administration has characterized those of us who are concerned about the environment. Du Pont is a pretty tough-minded, profit-oriented, bottom-line-oriented corporation, and in what I think was a very statesmanlike act, they said the globe cannot afford continued production of CFC's at any level.

How would you parse that out? What kind of action and what kind of leadership would you say our country ought to be taking? Should we be taking the lead to uphold the Montreal agreement to rapidly phase out CFC's everywhere? Should we hold on and protect that $400 million annual profit we can get from parceling out production rights?

I am asking you to come down from the mountain top with the tablets under your arm and tell us what is wise public policy, factoring in economic concerns, factoring in global survival concerns?

Mr. **Sprinkel**. It is an excellent question, and again in an area in which I have participated in meetings and I have read several papers. Mr. Moore knows a lot more about this subject as well as the health subject, and I would like for him to respond.

I am not trying to duck responsibility, but I learned a long time ago when you open your mouth you had better be talking about something you consider yourself well informed on because otherwise you will look very foolish.

And I am not an expert in that area, but Tom Moore is.

Mr. **Moore**. I think the administration takes great pride actually in the Montreal protocol. The first international agreement in history to restrict a pollutant and to phase it down. And it was our leadership that got it started and going. We have supported it all along.

Representative **Scheuer**. That is quite correct.

Mr. **Moore**. So, we take great pride in it. We had to get other countries to come on. It's not something that the United States can do unilaterally.

Of course, we could abolish CFC's unilaterally. The problem is——

Representative **Scheuer**. The statement that I made is that the Du Pont Corp. says that from the point of view of the global environment and global survival, we have to cut out CFC's.

Mr. **Moore**. Right. But we have to cut them out—we may have to cut them out worldwide.

Representative **Scheuer**. Of course, you have to cut them out worldwide.

Mr. **Moore**. If we are going to go that far, I think what we should do is phase down as the Montreal protocol calls for, phase down to a 50-percent cut. In the process, we are going to look at the science and see whether we should at that point go all the way. It may be easily that we should go all the way, but then we have to get the other nations of the world to go along with us. And this is not an easy job.

Now, your question about the $400 million, that is irrelevant. We are not going to keep this program. This was never envisioned as a revenue raiser. The purpose of making the change is, in fact, so that we encourage these companies to find substitutes. They are not making large profits on the remaining CFC's, they are being encouraged because they do not make the profits there to find alternative substitutes which are not causing the damage.

Ultimately, we would like to see if the science supports it. And you may be right if it does that we should go to zero. We would then expect the $400 million to go to zero. But it's not a revenue raiser, and nobody is going to try to protect that money at the expense of the environment.

Representative **Scheuer**. Would you assume arguendo that when the Du Pont Corp. says that on the basis of their research and on the basis of the ongoing—not progress—but ongoing evaluation of global warming, the "greenhouse effect" and the ozone hole—they say with a real sense of urgency on the basis of our research we ought to cut it out. When they say that sort of a rebuttable presumption that they may know what they're talking about?

Mr. **Moore**. They are a very responsible corporation, and I think their scientists are very good. We also have very good scientists in the U.S. Government. I have listened to them in hours of meetings, getting filled in on the science of this, also the "greenhouse effect," at this point I am convinced that phasing down the CFC's is important and desirable.

The Council did a calculation on the benefits and costs from this and the benefits of phasing it down are well in excess of any potential costs.

Representative **Scheuer**. OK, Mr. Sprinkel. Let me say, as this is your last appearance here, you have appeared many times before, and we have had our differences, we have had our debates. They have always been stimulating. You have always been stimulating.

You have been forthcoming. In that sense you have been a very cooperative and productive witness, and we thank you for your appearance here today as well as for the many, many other appearances in which we have enjoyed the benefit of your thinking, very openly expressed.

Thank you very much.

Mr. **Sprinkel**. Thank you, sir.

Representative **Hamilton**. Mr. Sprinkel, Mr. Meltzer, Mr. Moore, we are delighted to have had you. We thank you for your service to the Council and to the country. We wish you the very best.

We stand adjourned.

[Whereupon, at 12:25 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1989 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, JANUARY 31, 1989

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2175, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Solarz, Snowe, and McMillan; and Senators Sarbanes, Bingaman, and Gore.

Also present: Joseph J. Minarik, executive director; Robert J. Tosterud, minority assistant director; and William Buechner and Dale Jahr, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative Hamilton. The meeting of the Joint Economic Committee will come to order. This morning the Joint Economic Committee resumes its annual hearings on the economic outlook and the 1989 Economic Report of the President.

On January 18, these hearings began with testimony from the outgoing Council of Economic Advisers whose Chairman, Beryl Sprinkel, presented the Economic Report of the President to the committee.

Today we are very pleased to welcome the Honorable Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System. When Chairman Greenspan appeared before this committee last year, the main concern of the hearing was whether the stock market crash of October 1987 would cause a recession. Today, the focus of concern probably will be on the outlook for inflation.

During this morning's hearing, we hope to explore this concern with Chairman Greenspan and to discuss how the Federal Reserve, Congress, and the administration can address it. Equally important, we want to explore how current monetary and fiscal policies will affect the outlook for economic growth in 1989, the progress that has recently been made on reducing the unemployment rate, and the outlook for further improvements in the trade deficit. We, of course, want also to look beyond 1989 to examine the long run progress and the problems for the American economy.

The Chair has a written opening statement from Senator Bingaman which he would like to enter into the record and, without objection, we will do so.

[The written opening statement follows:]

WRITTEN OPENING STATEMENT OF SENATOR BINGAMAN

Mr. Chairman, as we begin this series of hearings on the economic outlook for 1989, I am troubled by a number of factors.

The first is the situation we have gotten ourselves into over the need for increased productivity and long term investment on the one hand and the use of rising interest rates to cool the economy and control inflation on the other -- a situation an editorial in yesterday's Washington Post called "the economic trap." Long term economic growth and a rising standard of living depend on increasing productivity and long term investment. With rising productivity, wages may increase without inflation. Yet, rising interest rates -- the mechanism to reduce inflation -- results in lower investment and lower productivity -- the very factors needed to prevent inflation.

The Post editorial states that if only we reduce the budget deficit, everything will work out fine. I am not convinced it will be that easy. Yes, reducing the Federal budget deficit is an important step toward solving our long-term economic problems. But, how we reduce the deficit is just as important. If we cut or eliminate those very programs needed to increase investment and productivity, then we will be penny wise and pound foolish.

In addition, if we concentrate only on the immediate problems of interest rates, we may neglect many of the other longer term actions we need to take, such as improving our educational system and strengthening our ability to commercialize technology. I would hope Mr. Greenspan today, and the witnesses in the hearings to follow, will give us the benefit of their wisdom on the long term economic problems facing us as well as their thoughts on the outlook for this year.

The second concern I have is over the growth in the disparity of income in our country. Over the past few years we have seen strong economic growth and there are signs of continued strong growth. Real GNP growth for the last quarter of 1988 was 2%. However, without the effects of the drought, real GNP is estimated to have been a strong 3.1%. Economists speak of the need for a slow down in growth, a so-called "soft-landing," to prevent a resurgence of inflation and a resulting dramatic reduction or even recession, a "hard-crash".

Yet, many in this country did not benefit from the economic boom. The economic recovery has done little to help the poorest Americans. As of 1987, 13.5% of all Americans continue to live below the poverty line and the head of the household in 85% of these families did not have a year-round, full-time job. Even for working Americans, the prosperity of the past few years has been somewhat illusory. Real hourly earnings for production workers remain well below their level of the 1970s - the decade of so-called "stagflation".

And not all regions of the country have benefited from our so-called prosperity. For example, in my home state of New Mexico, the rate of unemployment remains exceedingly high and growth of personal income remains low.

If we are now facing a period of slower economic growth, necessary to head off inflation, what hope can we offer those passed by over the past seven years? Have we already held the party and are we leaving these people to pay the bill?

Mr. Chairman, these are two of the more troubling longer-term questions facing our economy. While these hearings are meant to look at the economic outlook for this coming year, I do not believe we can afford to ignore the longer term problems. I hope this series of hearings will help shed some light on the difficulties facing our economy and propose some solutions.

Representative **Hamilton**. Mr. Greenspan, we turn to you now for your testimony and, of course, after that, for questions and responses by you. We welcome you before the committee. We are delighted to have you, and you may proceed.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. **Greenspan**. Thank you very much, Mr. Chairman.

I would like to put my full remarks in the record but excerpt some of them in my opening statement.

As you know, the Federal Reserve will submit its semiannual report on monetary policy to the Congress next month. That report will cover in detail the Federal Open Market Committee's policy targets for 1989, as well as our expectations for real growth and inflation. Today, I would like to focus on some of the broader considerations bearing on our economic prospects.

The overall record shows 1988 to have been another year of progress for the U.S. economy. Setting aside the effects on aggregate output of last summer's drought, real GNP rose more than 3 percent over the course of the year. That pace was considerably faster than was expected by many analysts at the start of the year, and it came on the heels of a strong 5-percent GNP increase in 1987. Especially encouraging in terms of the prospects for sustained expansion is that these surprising gains have been achieved without a flareup of inflation. Prices have accelerated only slightly, with increases in most broad indexes holding in the range of 4 to 4½ percent.

As we enter 1989, there are few signs of any significant impediments to continued expansion. Business cycle history tells us some places to look for danger signals. One of them is excessive accumulation of inventories; at present, overhangs of stocks are rather isolated and manageable. Another is overbuilding of capacity; while there are clearly a good many empty office buildings around the country, industrial capacity is relatively fully utilized—indeed, tight in some industries. Still another is out-of-control costs and inadequate margins; but again there appear to be no widespread problems.

This is not to say that we have little reason for concern. Resources utilization has risen to levels that at numerous times in the past have been associated with a worsening of inflation. If growth were to continue indefinitely at the recent pace, the concomitant tightening of supply conditions for labor and materials would risk a serious intensification of inflationary pressures at some not-too-distant point in the future.

How fast the economy can now grow without a significant pickup in inflation is obviously a key question. The answer depends, of course, on the amount of slack in labor markets and in industry and on prospects for the growth of labor and capital resources and of technological efficiency. Inflation in the longer term is essentially a monetary phenomenon. But excess pressures on productive resources have usually been the major trigger engendering financial tensions that too often have been relieved through inflationary monetary expansion. Unfortunately, such pressures can be extremely hard to discern in a timely way. Economic relationships are complex and difficult to pin down; the lags between changes in resource utilization and in prices can be long, and the translation into credit and financial excess inexact. Moreover, conventional measures of resource utilization may not be sufficiently sensitive to the increasing openness of the U.S. economy in recent years and to other changes in the economic structure. Nonetheless, a careful examination of the historical experience-in conjunction with a knowledge of demographic trends and other long-term development—provides ample evidence of where the risks lie.

The labor market is showing clear signs of tightening. Gains in employment exceeded 2 million last year, according to the Census survery of households; this outstripped the growth in the labor force, and the unemployment rate fell to its lowest levels since the 1970's. However, the demographic composition of the work force has changed considerably since the 1970's. And workers now seem to be placing greater emphasis on job preservation as opposed to bigger wage gains, while businesses strive to contain costs and to enhance competitiveness. Accordingly, the wage pressures associated with a 5¼ percent jobless rate today are less than they would have been 10 or 15 years ago. It also is unlikely a few tenths of a percentage point up or down on the unemployment rate would change the inflation outlook dramatically. Nonetheless, the available evidence points to a high probability of stepped-up wage pressures should unemployment decline significantly further.

In part, that assessment reflects the fact that unemployment now is well within the range of 4½ to 6½ percent that encompasses most estimates of the so-called natural rate of unemployment. The concept of a natural rate of unemployment, that is, a rate consistent with stable inflation over the long run, is a useful notion for empirical studies of the relationship between labor market tightness and inflation. Unemployment below the natural rate presumably would provide sustained impetus to inflation, while unemployment above the natural rate would tend toward disinflation. Any figure for the natural rate should be viewed cautiously, given the uncertainties and the complexities of the economic relationships involved; indeed, the most recent estimates are perceptibly lower than many analysts thought likely only a few years ago.

Nonetheless, increase in compensation—although volatile from quarter to quarter—picked up roughly 1½ percentage points last year, to approximately 5 percent for the year as a whole. Pay gains in many occupations and regions of the country where labor demand has been especially strong have been somewhat greater. In the Northeast, for example, hourly compensation increased 6 percent. Reports of labor shortages and wage pressures are widespread in some regions, and there is some fear that the tenor of wage negotiations may shift in a direction inimical to cost restraint.

Measures of industrial supply conditions are more ambiguous, but on the whole also point to a tightening. Utilization rates for plant and equipment—as in the labor market—have moved up sharply over the past few years. Capacity utilization in manufacturing, after hovering around 80 percent from 1984 to mid-1987, has climbed to 84½ percent. Some industries, including steel, paper, and chemicals, have been operating flat out, or close to it.

The conventional measures, however, may well overstate the degree of price pressure. Capacity is a somewhat elusive concept. For example, facilities can be moved in and out of use or put on different operating schedules in response to fluctuations in demand and prices. Moreover, measures of domestic capacity do not take account of the availability of materials and supplies from abroad—a factor of some importance in our increasingly open economy. Indeed, information compiled by the National Association of Purchasing Management suggests that what we may term "deliverability," was dimishing only moderately at yearend, after a marked deterioration in 1987 and early 1988. Vendors were missing their schedules less often, while average leadtimes for orders of production materials were no longer than they were a year earlier.

Our estimates of aggregate production capacities clearly are imprecise. Moreover, labor markets and industrial facilities may well be flexible enough to allow us to operate for some time at higher levels of resource utilization without a visible deterioration in inflation. But there is little doubt that margins of slack have been reduced. The risk of greater inflation could be appreciable if real GNP continued to increase at recent rates over the next several years.

With most of the slack having been taken up, our growth will tend to be limited by the rate at which our productive capacity expands. Most estimates place the growth in productive capacity—or long-term potential GNP—in the area of 2½ to 3 percent per year. Growth of the labor force has dropped markedly since the 1970's; given the trends in the working-age population, in participation rates, and in the average workweek, such growth is likely to remain relatively slow in coming years. And while one can hope for some offset from better labor productivity performance, the improvements we've seen to date in the economywide data have not been dramatic. Gains in nonfarm business productivity have picked up somewhat in the 1980's, but—at only about 1¼ percent per year—they fall far short of those recorded in the 1950's and the 1960's. In part, the disappointing productivity performance reflects the low level of net investment.

To be sure, we have not had great success in forecasting intermediate shifts in productivity in years past. It is possible that forces not now visible can impart a significant upward push to productivity. This could boost potential economic growth beyond 3 percent a year. However, a policy that assumes such outcomes risks significant inflationary imbalances.

Containing the pressures on labor and capital resources—while continuing to reduce our external imbalance—will require a slowing in domestic demand. Such an outcome will be facilitated to the extent that the Federal budget deficit is reduced. With the Gramm-Rudman-Hollings procedures providing some discipline on spending decisions, the budget looks to be a mildly restraining influence on domestic demand this year. But it is crucial that further steps be taken in support of a long-term policy of reducing budget deficits and the associated claims on the Nation's savings.

Lower deficits will pay off over the longer run: they will free up domestic savings to finance investment that embodies the most up-to-date technology. Therein lies a major hope for attaining the productivity gains so crucial to the growth in potential GNP. In the 1980's, a large inflow of capital from abroad has made it possible to finance both the Federal budget deficit and a high level of gross private investment without untenable pressures on credit markets. However, a country cannot depend forever on foreign saving; at some point we will have to rely more fully on our own resources. The paucity of aggregate domestic saving in recent years has been exacerbated by a sharp fall in private saving, and we cannot count on a major reversal of that trend. We have endeavored in the past few decades to implement tax policies to augment household and business saving; by all accounts, they have met with only limited success. Accordingly, the surest way to overcome the shortage of domestic saving is through sizable reductions in budget deficits.

Monetary policy also will bear importantly in our economic prospects, and I will be reporting to the Congress next month on the Federal Reserve's plans for monetary policy in 1989. Fundamentally, our strategy continues to be centered on moving toward, and ultimately reaching, stable prices. The pursuit of such a strategy embodies an acute awareness of the great cost to our economy and society should a more intense inflationary process become entrenched. The experience of the past two decades vividly illustrates the problems that arise when accelerating prices and wages have to be countered later by severely restrictive policies.

Let me conclude, Mr. Chairman, by saying that I view our economic prospects in 1989 and beyond as favorable, but that such an outcome is no means assured. I have spoken to the risk of rising inflation when labor and product markets are operating at or near full capacity. The deficits in the Federal budget and in our external accounts also are serious problems that must be dealt with. However, if we remain attentive to the course of events and take prudent actions on a timely basis, I am optimistic that we can make further progress toward the objectives of full employment and price stability.

Thank you.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF HON. ALAN GREENSPAN

I am pleased to appear before this committee to discuss the current economic situation and the outlook for 1989. As you know, the Federal Reserve will submit its semiannual report on monetary policy to the Congress next month. That report will cover in detail the FOMC's policy targets for 1989, as well as our expectations for real growth and inflation. Today, I would like to focus on some of the broader considerations bearing on our economic prospects.

The overall record shows 1988 to have been another year of progress for the U.S. economy. Setting aside the effects on aggregate output of last summer's drought, real GNP rose more than 3 percent over the course of the year. That pace was considerably faster than was expected by many analysts at the start of the year, and it came on the heels of a strong 5 percent GNP increase in 1987. Especially encouraging in terms of the prospects for sustained expansion is that these surprising gains have been achieved without a flare-up of inflation. Prices have accelerated only slightly, with increases in most broad indexes holding in the range of 4 to 4-1/2 percent.

As we enter 1989, there are few signs of any significant impediments to continued expansion. Business cycle history tells us some places to look for danger signals. One of them is excessive accumulation of inventories; at present, overhangs of stocks are rather isolated and manageable. Another is overbuilding of capacity; while there clearly are a good many empty office buildings around the country, industrial capacity is relatively fully utilized--indeed, tight in some industries. Still another is out-of-control costs and inadequate profit margins; again, there appear to be no widespread problems.

However, this is not to say that we have little reason for concern. Resource utilization has risen to levels that at numerous times in the past have been associated with a worsening of inflation. If growth were to continue indefinitely at the recent pace, the concomitant tightening of supply conditions for labor and materials would risk a serious intensification of inflationary pressures at some not too distant point in the future.

How fast the economy can now grow without a significant pickup in inflation is obviously a key question. The answer depends, of course, on the amount of slack in labor markets and in industry and on prospects for the growth of labor and capital resources and of technological efficiency. Inflation in the longer term is essentially a monetary phenomenon. But excess pressures on productive resources have usually been the major trigger engendering financial tensions that too often have been relieved through inflationary monetary expansion. Unfortunately, such pressures can be extremely hard to discern in a timely way. Economic relationships are complex and difficult to pin down; the lags between changes in resource utilization and in prices can be long, and the translation into credit and financial excess inexact. Moreover, conventional measures of resource utilization may not be sufficiently sensitive to the increasing openness of the U.S. economy in recent years and to other changes in the economic structure. Nonetheless, a careful examination of the historical experience--in conjunction with a knowledge of demographic trends and other long-run developments--provides ample evidence of where the risks lie.

The labor market is showing clear signs of tightening. Gains in employment exceeded 2 million last year, according to the Census survey of households; this outstripped the growth in the labor force, and the unemployment rate fell to its lowest levels since the 1970s. However, the demographic composition of the work force has changed considerably since the 1970s. And workers now seem to be placing greater emphasis on job preservation as opposed to bigger wage gains, while businesses strive to contain costs and to enhance competitiveness. Accordingly, the wage pressures associated with a 5-1/4 percent jobless rate today are less than they would have been 10 or 15 years ago. It also is unlikely that a few tenths of a percentage point up or down on the unemployment rate would change the inflation outlook dramatically. Nonetheless, the available evidence points to a high probability of stepped-up wage pressures should unemployment decline significantly further.

In part, that assessment reflects the fact that unemployment now is well within the range of 4-1/2 to 6-1/2 percent that encompasses most estimates of the "natural rate" of unemployment. The concept of a natural rate of unemployment, that is, a rate consistent with stable inflation over the long run, is a useful notion for empirical studies of the relationship between labor market tightness and inflation. Unemployment below the natural rate presumably would provide sustained impetus to inflation, while unemployment above the natural rate would tend toward disinflation. Any figure for the natural rate should be viewed cautiously, given the uncertainties and the complexity of the economic relationships involved; indeed, the most recent estimates are perceptibly lower than many analysts thought likely only a few years ago.

Nonetheless, increases in compensation--although volatile from quarter to quarter--picked up roughly 1-1/2 percentage points last year, to approximately 5 percent. Pay gains in many occupations and regions of the country where labor demand has been especially strong have been somewhat greater. In the Northeast, for example, hourly compensation increased 6 percent. Reports of labor shortages and wage pressures are widespread in some regions, and there is some fear that the tenor of wage negotiations may shift in a direction inimical to cost restraint.

Measures of industrial supply conditions are more ambiguous, but on the whole also point to a tightening. Utilization rates for plant and equipment, as in the labor market, have moved up sharply over the past few years. Capacity utilization in manufacturing, after hovering around 80 percent from 1984 to mid-1987, has climbed to 84-1/2 percent. Some industries, including steel, paper, and chemicals, have been operating flat out, or close to it.

The conventional measures, however, may well overstate the degree of price pressure. Capacity is a somewhat elusive concept. For example, facilities can be moved in and out of use or put on different operating schedules in response to fluctuations in demand and prices. Moreover, measures of domestic capacity do not take account of the availability of materials and supplies from abroad--a factor of some importance in our increasingly open economy. Indeed, the information compiled monthly by the National Association of Purchasing Management suggests that what may be called "deliverability" was diminishing only moderately at year-end, after marked deterioration in 1987 and early 1988. Vendors were missing their schedules less often, while average lead times for orders of production materials were no longer than they were a year earlier.

Our estimates of aggregate production capabilities clearly are imprecise. Moreover, labor markets and industrial facilities may well be flexible enough to allow us to operate for some time at higher levels of resource utilization without a visible deterioration in inflation. But there is little doubt that margins of slack have been reduced. The risk of greater inflation could be appreciable if real GNP continued to increase at recent rates over the next several years.

With most of the slack having been taken up, our growth will tend to be limited by the rate at which our productive capacity expands. Most estimates place the growth in productive capacity--or long-term potential GNP--in the area of 2-1/2 to 3 percent per year. Growth of the labor force has dropped markedly since the 1970s; given the trends in the working-age population, in participation rates, and in the average workweek, such growth is likely to remain relatively slow in coming years. And while one can hope for some offset from better labor productivity performance, the improvements we've seen to date in the economy-wide data have not been dramatic. Gains in nonfarm business productivity have picked up somewhat in the 1980s, but--at only about 1-1/4 percent per year--they fall far short of those recorded in the 1950s and '60s. In part, the disappointing productivity performance reflects the low level of net investment.

To be sure, we have not had great success in forecasting intermediate shifts in productivity in years past. It is possible that forces not now visible could impart a significant upward push to productivity. This could boost potential economic growth beyond 3 percent per year. However, a policy that assumes such outcomes risks significant inflationary imbalances. I think it is wiser to have "money in the bank before we spend it," so to speak.

Containing the pressures on labor and capital resources--while continuing to reduce our external imbalance--will require a slowing in domestic demand. Such an outcome will be facilitated to the extent that the federal budget deficit is reduced. With the Gramm-Rudman-Hollings procedures providing some discipline on spending decisions, the budget looks to be a mildly restraining influence on domestic demand this year. But it is crucial that further steps be taken in support of a long-term policy of reducing budget deficits and the associated claims on the nation's saving.

Lower budget deficits will pay off over the longer run: they will free up domestic saving to finance investment that embodies the most up-to-date technology. Therein lies a major hope for attaining the productivity gains so crucial to growth in potential GNP. In the 1980s, a large inflow of capital from abroad has made it possible to finance both the federal budget deficit and a high level of gross private investment without untenable pressures on credit markets. However, a country cannot depend forever upon foreign saving; at some point we will have to rely more fully on our own resources. The paucity of aggregate domestic saving in recent years has been exacerbated by a sharp fall in private saving, and we cannot count on a major reversal of that trend. We have endeavored in the past few decades to implement tax policies to augment household and business saving; by all accounts, they have met with only limited success. Accordingly, the surest way to overcome the shortage of domestic saving is through sizable reductions in budget deficits.

Monetary policy also will bear importantly on our economic prospects, and I will be reporting to the Congress next month on the Federal Reserve's plans for monetary policy in 1989. Let me comment, however, on the notion I hear all too frequently that current rates of inflation are acceptable to the Federal Reserve. Fundamentally, our strategy continues to be centered on moving toward, and ultimately reaching, stable prices, that is, price levels sufficiently stable so that expectations of change do not become major factors in key economic decisions. Current inflation rates, by that criterion, clearly are too high and must be brought down. Progress toward that goal in 1988 was inhibited by the lagged effects of the sharp decline in the dollar over the 1985-87 period and by the drought-induced flare-up in food prices. However, the dollar now is at levels where U.S. industry is quite competitive. Of course, we recognize that achieving the joint goals of growth and price stability will require persistence and patience. To the extent that labor and management perceive our commitment, the dynamics of the wage-price process will work in our favor.

The pursuit of such a strategy on the part of the Federal Reserve embodies an acute awareness of the great cost to our economy and society should a more intense inflationary process become entrenched.

The experience of the past two decades vividly illustrates the problems that arise when accelerating prices and wages have to be countered later by severely restrictive policies. There are unavoidable adverse implications for production and employment, as well as for the financial health of many individuals and businesses. For that reason, it is our judgment--as I indicated to the Congress last July--that the long-run costs of a return to higher inflation, and the risks of this occurring under current circumstances, are sufficiently great that Federal Reserve policy at this juncture might well be advised to err more on the side of restrictiveness than of stimulus.

Let me conclude by saying that I view our economic prospects in 1989 and beyond as favorable, but that such an outcome is by no means assured. I have spoken at length of the risk of rising inflation when labor and product markets are operating at or near full capacity. The deficits in the federal budget and in our external accounts also are serious problems that must be dealt with. However, if we remain attentive to the course of events and take prudent actions on a timely basis, I am optimistic that we can make further progress toward the objectives of full employment and price stability.

Representative **Hamilton**. Thank you very much, Mr. Greenspan.

We will proceed on the basis of the 10-minute rule, and I will ask the staff to keep close track of that so that Congressmen and Senators may have a chance to question Mr. Greenspan. We appreciate very much your statement.

I noticed the emphasis in your statement early on, on the prospects of maintaining economic growth. Can we avoid a recession in the next few years?

Mr. **Greenspan**. Theoretically, we certainly can. There is nothing in the current balance of the economy which in any way, in my judgment at least, predisposes us to a recession.

History, however, suggests that we will eventually have one, and that will occur because imbalances will arise, economic policy will not be successful in countering it, and an adjustment will take place.

We must assume, obviously at some point in the future, that there will be a recession because I know of nothing which suggests to me that the business cycle has been repealed.

Representative **Hamilton**. There are two schools of thought out there on recessions. One is that the current expansion can go on indefinitely unless policymakers make mistakes and bring about a recession. Another school of thought is that there is, as you suggested in your last sentence there, that there's a natural business cycle that will inevitably bring expansion to an end, regardless of what the Government policies are.

Do you subscribe to one or the other?

Mr. **Greenspan**. Actually, I would subscribe fully to neither. I think that there are many elements that can occur relatively spontaneously in the business environment which have nothing to do with government policies. For example, there can be a significant endeavor on the part of business to accumulate inventories for fear that there will be inadquate supplies. If that inventory investment takes on inordinately large dimensions, it almost surely will tilt the economy into a recession irrespective of what government policy is.

On the other hand, there is nothing indigenous to the process itself which creates an inevitability of a recession. In other words, despite the fact that the recovery is now more than 6 years old, it doesn't have many of what might be termed "geriatric" characteristics of an economy expanding for that period of time.

As I indicated in my opening remarks, we do not have at this stage any evidence of inventory imbalance, which is usually a key element in any pending set of recessionary forces. We don't have a really major capacity expansion boom going on which usually is a signal that we're peaking and that will eventually end, nor do we have a really disturbing acceleration of inflation. We have an upcreep which is worrisome, but we're not at a point where imbalances are being generated.

Representative **Hamilton**. Is there any threat that the recent rise in the interest rates would cause a recession?

Mr. **Greenspan**. I think not. As best we can judge, what the rise to date has done is suppressed some of the forces which could create instability, specifically inventory accumulation and inflation, and, in that regard I would say it is more likely to extend the recovery than to bring it to an early halt.

Representative HAMILTON. Let me ask your a procedural question which was brought to my mind by a phrase that President Bush used in responding to the question of growth and inflation. He said, "I haven't talked to Alan lately."

I just wonder to what extent the Chairman of the Federal Reserve and the President of the United States, you as the chief monetary policy person, the President as the chief fiscal policy person, to what extent have you worked out with the President, if you do, a regular communication back and forth?

Mr. GREENSPAN. We do not at this stage have one, but we surely shall.

Representative HAMILTON. You favor such a regular communication?

Mr. GREENSPAN. Indeed I do.

Representative HAMILTON. How would you structure it?

Mr. GREENSPAN. First of all, there is an organization which meets periodically and has for years, called the Quadriad, which comprises the Chairman of the Council of Economic Advisers, the Secretary of the Treasury, the Director of OMB, and the Chairman of the Federal Reserve.

Over the years, we have met periodically for purposes of coordinating policy, since there is only one policy for the U.S. Government. That group periodically meets with the President, as indeed we did with President Reagan from time to time.

Representative HAMILTON. But at this point in time, you don't have any set meetings; is that right?

Mr. GREENSPAN. No, I do not. I have, however, met with the then-President-elect, prior to his inauguration, and indicated that such meetings would be desirable, and he was, as I recall, quite amenable to that.

Representative HAMILTON. Would that mean you would meet with his top economic advisers and not with him?

Mr. GREENSPAN. No. I think it would be both.

I have all intentions to continue meeting with the other policymakers, especially, of course, the Secretary of the Treasury with whom I meet very often, and periodically to meet with the President.

Representative HAMILTON. Now, a question about the Fed's policy with respect to intervention in the financial markets.

You have been raising short-term interest rates in order, I presume, to slow the growth of the economy. That has attracted some foreign investors. It has put upward pressure on the dollar. At the same time, the Fed and other central banks have been selling dollars to keep its value from rising.

Does the U.S. Government have a target for the dollar and, if so, what is that target?

Mr. GREENSPAN. Mr. Chairman, we don't have a specific target, but it is the policy of the G–7 to have a general range in which we define various bilateral exchange rates as being in an area of stability, which is the underlying policy thrust of the G–7 countries.

In the last year or so, I would say that the coordination of the G–7 with respect to exchange markets has, in my judgment, been sufficiently successful to create a degree of stability in various major bilateral exchange rates, enough stability that the uncertainties that were created in the world markets when exchange rates were extraordinarily volatile has, to a large extent, been removed. I think that's a very major plus and a tribute to the coordination that has gone on.

Representative HAMILTON. The Germans, for example, have been selling dollars to keep the mark from falling, which of course would stimulate inflation in Germany.

Does the Fed sell dollars here to help the Germans or do we have our own purposes in intervening?

Mr. GREENSPAN. Our purposes to the extent that we intervene, are obviously domestically focused and must be consistent with American economic policy. But it is also our view that the success of American policy and the prosperity of the United States is not independent of what is occurring throughout the world, and we find it very much to our own advantage to coordinate with our colleagues in the G-7 in economic policy positions on the grounds that we perceive it to be to the good of all. That, in my judgment, is consistent with our fundamental purpose: namely, to make certain that the American economy is functioning in as optimum a way as we can make it function.

Representative HAMILTON. Do you consider that finetuning the economy?

Mr. GREENSPAN. No, I don't. I think that finetuning has a connotation which requires, in a sense, that you try to go from one policy to another and often put yourself in a position where you're whipsawed.

I consider the policies that we are involved in are a stabilization set of actions which endeavor to dampen rather than finetune.

Representative HAMILTON. We are accustomed to hearing on this committee in years past that you only intervene if there are disorderly markets. That was the position taken by a previous Secretary of the Treasury, for example.

And yet it seems to me in recent years we have seen very frequent and even massive intervention by the central banks, both the Fed and the central banks of the other countries as well. That surely represents a change of policy for us and, to some extent, moves us in the right direction of finetuning the economy.

Mr. GREENSPAN. I think it's an issue of terminology. That there has been a change in policy, yes, there certainly has been. The reason for the change is that it was perceived by the G-7 finance ministers and central banks that exchange rate instability was creating adverse consequences in the world and inducing potential destabilizing impulses to the major economies, and it was the judgment of the G-7 that stabilization was something which could and should be undertaken.

Looking back at the record, I would say that it has been successful and that the desirability of going in that direction was clearly correct.

Representative HAMILTON. Congressman McMillan.

Representative McMILLAN. Thank you, Mr. Chairman.

Welcome, Chairman Greenspan. We are always delighted to have you here.

I'd like to ask you to comment on some things that perhaps may be asking you to fire a few shots before you are totally prepared to deliver your report next month. But we're moving into the budget considerations, and we have been for some time. We have a forecast from the prior administration that we're currently working with until and if we receive something different that assumes a real growth rate year to year of 3.2 percent, and inflation rate of 3.6 percent as measured by the GNP deflator, interest rates of 5½ percent on Treasury bills, and 7.2 percent on 10-year Treasury obligations.

Would you care to comment on the validity of any of those assumptions as you currently see them?

Mr. GREENSPAN. There is a crucial caveat in that forecast, and that is that the Congress, relatively quickly, passes in toto President Reagan's budget. If in fact there is a major move by the Congress to pass something which looks similar to that budget, with a dramatic decline in the deficit as well as a projection of a surplus within several years, that could have rather extraordinary effects on financial markets. It would, as I have said in other fora, bring interest rates down.

I don't think at this stage—already well into 1989—you can create the level of interest rates that are in the projection of the Reagan budget for calendar year 1989. But I don't find at least the direction of change in their interest rates for, say, 1990 particularly inconsistent with their budget assumptions.

Under those conditions the real growth rate, which as I understand it excludes the drought effects which are quite substantial, of 2.8 percent from the fourth quarter of 1988 to the fourth quarter of 1989, is a little bit stronger than I would probably think likely, but it's well within the range of reasonableness, especially in the context of the assumption that the budget will be brought under control and dramatically reduced within a relatively short period of time.

Representative MCMILLAN. To follow that up a little bit, the forecast and the budget assume that that set of assumptions would produce increased revenues of approximately $84 billion, which would enable the Congress and the President to meet the Gramm-Rudman-Hollings deficit reduction targets without any significant tax increase.

If that in fact occurred, do you think it would then address the issue of inflation, the possible resumption of inflation sufficiently so that Fed policy would then respond to that, and in fact tend to bring about the lower interest rates that are projected in the assumption?

Mr. GREENSPAN. I would say that if we get a credible reduction in the budget deficit, not only for fiscal year 1990, but a set of authorizations and appropriations which lead the markets, skeptical as they are, to project a further reduction in the deficit so that it is moving very dramatically lower, then we would see a fairly pronounced decline in long-term interest rates as inflation premiums would come down, and I think that would filter back into the short end of the market.

In a sense, the markets would be driven by the pressures of supply and demand for credit in a manner in which the Federal Reserve could be passive and rates would fall.

Representative McMILLAN. Thank you.

Let me just shift a minute to interest rates as such. In your judgment, the rise over recent months in short-term rates has been driven primarily by what? Is it policy driven or market driven?

Mr. GREENSPAN. It has basically been a combination of both, but clearly we at the Federal Reserve have been most concerned about the potential emergence of inflationary forces which could undercut the recovery and create the types of instabilities which we fought so hard to remove in years past.

It is essentially that concern on our part that led to a policy of firming from the early months of last year through the end.

Representative McMILLAN. There has been some commentary in the financial media, or perhaps among analysts, on the so-called inverted yield curve; that is, higher short-term rates than long-term rates. Is this a signal of a recession?

Would you care to address those kinds of forecasts?

Mr. GREENSPAN. Speaking merely analytically, I find that difficult to agree with. It is certainly the case that if one looks at past periods of sharply rising short-term rates relative to long-term rates, they have preceded recession. But I think that they were also periods in which inventory accumulation was moving up dramatically.

In fact, one of the reasons why short-term rates were rising so dramatically in the past, prior to recessions, was the demand for short-term credit finance. A good deal of inventory accumulation and short-term speculative activity was driving short-term rates.

It was, however, the inventory instabilities and the inflationary instabilities which generated the recessionary pressures, not the tilt of the yield curve. And I would say that in today's environment, we are looking at a rising or a flattening yield curve which is the result not of speculative short-term demands for credit, but rather an endeavor on the part of the Federal Reserve to suppress such pressures and, in the process, that has moved interest rates somewhat higher.

In other words, our endeavor to reign in potential short-term inflationary imbalances has moved short-term rates higher. It also, however, has apparently lowered or stabilized inflation premiums embodied in long-term interest rates. And so in that respect, there's no doubt that our policies have in part led to the yield curve tilting. But I would scarcely argue that it is the same set of relationships which in the past have engendered recessions.

Representative McMILLAN. Thank you, Mr. Chairman. My time has expired.

Representative HAMILTON. Senator Bingaman.

Senator BINGAMAN. Thank you, Mr. Chairman.

Mr. Greenspan, on this same issue of interest rates, to what extent does the huge dependence upon foreign funds coming into our economy affect the ability of interest rates to drop in the next year or so? I know some analysts are suggesting that slowdown in the economy would result, of course, in a lesser demand for funds and substantial reduction in the interest rates.

I wonder to what extent is the likelihood of that being reduced because of our dependence on foreign sources of money?

Mr. **Greenspan**. Senator, there is a complex set of relationships there. For example, there have been occasions in the last several years in which it is quite likely that it was the demand for U.S. dollars and, in a sense, the opening up of our current account deficit, that probably moved interest rates lower rather than higher, in the sense that there was a net demand for U.S. dollars-denominated instruments, and that, in turn, was one of the reasons why the dollar was firming so sharply from the early 1980's through February or March 1985.

That situation clearly changed, and there is now an increasing concern that in order to finance the current deficit, interest rates must be higher than they otherwise would be to attract foreign savings.

I would suspect that there is a good deal of truth in that, but the exact degree to which rates are higher than they would otherwise have been I would say is difficult to make a judgment on.

Senator **Bingaman**. Isn't this an unprecedented circumstance? I mean when we look ahead at a possible slowdown in our economy, can't we look back and say that the impact of dependence on foreign funds will be such and such because of the measurements we made in previous circumstances.

When we had the 1982 recession, our dependence on foreign borrowing was not near as great as it is today. Is that correct?

Mr. **Greenspan**. That is correct.

Senator **Bingaman**. So really the impact of that foreign borrowing is not something we have any real sense of what that would do to interest rates.

Mr. **Greenspan**. I would certainly agree with that, Senator. I think that this period is without real precedent in American economic history, and precisely how it will evolve and how policy will interact is not be any means clear at this stage.

Senator **Bingaman**. The trade deficit itself has come down some this year in 1988, and a lot of that is attributed to the reduction in the value of the dollar relative to other currencies.

Is it your view that the trade deficit will continue to come down substantially more without us once again revaluing the dollar, without it becoming revalued relative to other currencies?

Mr. **Greenspan**. Yes, Senator, I believe so.

First of all, I think it's important to remember that we had an extraordinary improvement in the trade deficit, one which was clearly not projected in the early months of last year.

I think it was virtually inevitable that we would get a stalling out, at least temporarily, of that process. In other words, we came down very sharply, and we have now stabilized for a time.

I think there is another tranche due at existing exchange rates. One reason is that we do have evidence at this stage that the export orders that are currently being placed at today's exchange rates are at a higher level than export shipments, meaning unfilled orders for exports are rising.

That suggests to me that American export industries are still quite competitive, and there is every reason to believe that we will be getting relatively strong export performance throughout 1989 and, presumably, a resumption of the decline in the trade deficit as well.

Senator BINGAMAN. You meant to say a reduction in the climb of the trade deficit? Is that what you said there at the end?

Mr. GREENSPAN. No. We have at the moment stalled out, so to speak, on the deficit. I think that the trade deficit will continue to decline later this year.

Senator BINGAMAN. Let me cite you one countertrend and get your assessment of the extent to which it would have an impact on the overall trade deficit.

Our dependence on foreign oil is growing. The price of oil has gone up in recent months. That is a significant item in our trade deficit. All the trends I've seen are that at least the volume of imported oil and petroleum products is going to continue rising over the next several years.

To what extent is that going to cancel out any benefits that we achieve through greater export of manufactured products?

Mr. GREENSPAN. Senator, I think it cancels it out, in part. That is, one of the negatives in the trade outlook is clearly the increased volume of oil imports because remember that even though the sharp rise in oil prices in the 1970's dramatically slowed and, for a while, decreased consumption of oil in the United States, the drop in oil prices has reintroduced an upward creep in domestic demand for oil. Largely because our domestic productive capabilities are beginning to tilt downward—specifically, stripper well capacity and some of the capacity in the lower 48 States—the arithmetic implies a fairly consistent progressive rise in the volume of imports.

Unless oil prices decline over the next several years—and I don't think that's a reasonable expectation—one must assume that the dollar amount of oil imports will be rising.

Senator BINGAMAN. You indicate in your statement that one of the clear ways of improving productivity is to bring down the domestic deficit and thereby provide additional funds for investment in plant and technology.

You also indicate that our efforts to use the tax laws to stimulate private investment have generally failed or have not been near as successful.

Mr. GREENSPAN. I wouldn't say they have failed. I would say they have clearly fallen far short of any reasonable expectations.

Senator BINGAMAN. The question is: What else can we do to try to get productivity improvements back to a more reasonable level?

Mr. GREENSPAN. I think that clearly the major need is to get net domestic investment in productive facilities rising. Net investment has in fact been declining, and it has become a progessively smaller percent of the GNP in recent years.

A necessary condition for an acceleration in productivity is that we bring up our level of investment, which is another way of saying that we need more in the way of domestic savings to finance it. That can occur either by increasing private savings and/or lowering the Federal budget deficit.

In addition, however, I do think that that there are forces which drive productivity other than physical investment, such as education. My impression is that our educational skills have to be augmented if we are to have an ability to employ the type of high-technology equipment which clearly is going to be the source of accelerated productivity in the decade ahead.

Senator **Bingaman**. Thank you very much, Mr. Chairman. My time is up.

Representative **Hamilton**. Congresswoman Snowe.

Representative **Snowe**. Thank you, Mr. Chairman.

I want to welcome you, Mr. Greenspan, here this morning. I wanted to talk a little bit about the credibility of economic assumptions. Last year the administration offered economic assumptions which were widely criticized, and yet ultimately results exceeded everybody's projections and expectations.

You mentioned a big "if" this morning. You said that you could accept the economic assumptions if President Reagan's budget would be accepted by Congress. Obviously that's not going to happen, so what President Bush recommends in terms of modification of President Reagan's budget may make a big difference and have an impact on the economy.

What does that portend if, for example, he doesn't make substantial reductions in spending and yet accepts, obviously, the economic assumptions of the Reagan budget?

Mr. **Greenspan**. First of all, as far as I understand it, the President will be adhering to the requirements of Gramm-Rudman-Hollings, and therefore, while obviously he has the capability of reshuffling a goodly part of what's in outgoing President Reagan's budget, he is nonetheless constrained within the law.

I would stipulate that if a budget is presented by President Bush which follows the Gramm-Rudman-Hollings guidelines and is implemented, I think that the effects would be really quite dramatic and quite favorable to the economy and to the overall financial system.

I think you are quite right in bringing up the issue of the fragility of economic assumptions. We make rather broad assumptions about economic activity as though it's directly related to the budget and to monetary policy, but there is really quite a wide range of possible outcomes that can occur. Even when you go from economic assumptions to budget receipts, for example, there is still a good deal of slack in those estimating procedures.

I notice, for example, that the CBO's receipts in the budget are higher than OMB's, even though CBO's economic assumptions, both with respect to nominal and real GNP, are lower.

So there is a degree of fragility in these estimating procedures.

Representative **Snowe**. To follow up on this entire issue as far as deficit reduction is concerned, how crucial is timeliness in the budget process for Congress and the President to agree on a deficit reduction program early on this session?

There is potential for a protracted battle here in Congress, between Congress and the President, and ultimately we rely on sequestration of Gramm-Rudman if we fail to achieve a budget package.

So one is the question of timeliness, and second is the consensus rather than relying on automatic cuts of Gramm-Rudman.

Mr. **Greenspan**. Obviously, the sooner such an agreement fulfilling Gramm-Rudman targets is in place, the better. I don't think it's an immediate emergency which requires that there be crisis management. But clearly I think it's not an issue which we can or should protract indefinitely into the future.

I am referring to this year. I'm not saying that something has to be done next week, or in two weeks, or a month or so, but obviously, the sooner the better. It's not something which, as far as I'm concerned, everything else must stop and a solution immediately be accomplished in the next matter of weeks, but it does have to be addressed successfully this year, and preferably, the sooner the better.

Representative SNOWE. Successfully. Does that mean going beyond the Gramm-Rudman targets or not relying on Gramm-Rudman automatic cuts to achieve deficit reduction, but rather having a budget adopted by Congress and the President?

Mr. GREENSPAN. I think that the Congress, irrespective of the means by which it is accomplished, has to have a budget in place which projects a major reduction in the deficit for the years ahead, in a manner which is credible to external observers, most specifically the financial markets, and that it be done sooner rather than later.

Representative SNOWE. So a multiyear trend is important for deficit reduction as opposed to one year in terms of automatic cuts, I gather.

Mr. GREENSPAN. Oh, I would go further. I would say that multiyear trend is what it's all about. I, frankly, would be less concerned about what any individual year showed, provided that the structure of the law and processes with respect to authorization and appropriation were so fixed as to create a credible, sharp reduction in the deficit throughout the early 1990's.

I certainly hope that the Congress moves expeditiously on this, but I don't want to give you the impression that if it doesn't happen next week, it's a crisis.

Representative SNOWE. I understand.

But it is important that we can ill afford to rely on automatic cuts is the message.

Mr. GREENSPAN. I'm sorry.

Representative SNOWE. We can ill afford to rely on the automatic cuts of Gramm-Rudman in the final analysis if we fail to achieve a budget between Congress and the President.

Mr. GREENSPAN. I would say it is not the way that one should budget, but I would say to you that if we are confronted with an abandonment of the Gramm-Rudman procedures or sequestration, a choice of two very unfavorable outcomes, I myself would prefer, as bad as it is, sequestration.

Representative SNOWE. Does it matter how we reduce the deficit, whether it's spending only or spending and taxes, as far as the impact is on the economy?

Mr. GREENSPAN. Yes, I believe it does, because if the purpose is to reduce the deficit, in my judgment it is far more successfully implemented if it is done substantially, hopefully exclusively, on the side of expenditures because even though I know there are a number of econometric studies which raise questions as to whether or not tax increases reduce the deficit, as I read the numbers and the culture of our society and the Congress, I find it very difficult to believe that a large part of deficit reduction coming from the tax side will, in the long run, be able to be implemented.

I don't deny that, in the short term, obviously you can bring the deficit down quickly, but since it's not the short term that matters, but the projection in the longer term, I think we will have far more successful longer term deficit reduction if we concentrate on the expenditure side.

Representative SNOWE. You referred to our low savings rate in this country. You mentioned that we cannot count on a major reversal of that trend.

What impact, or to what extent has the savings and loan industry's crisis had an impact on the savings rate in this country, and particularly in light of the recent recommendation, one of the options proposed for a fee on the depositor? Would that have any impact on the savings rate in this country at this point?

Mr. GREENSPAN. I would doubt it very much. I think that, first of all, there's nothing that I can see in the data which suggest that the overall private household savings rate has been influenced by the savings and loan crisis.

Also, remember that we have what I would consider to be rather impressive evidence that tax credits have not increased savings. In other words, I don't think that the huge increase in IRA's which we have as a consequence of the Tax Code has really appreciably affected net overall savings.

In my judgment, what we unfortunately have been observing is a shift from one account to the other. I'm not saying that the IRA has had zero effect on savings, but I think it's been very small.

If one argues that a tax cut does not effectively influence the savings rate, then any form of increase in a fee can't be an issue either. So one can argue the pluses and minuses on that proposal, but I don't think that one can successfully argue that it is something which would reduce the savings rate, because frankly I doubt that were it implemented, it would.

Representative SNOWE. But we did lessen the attractiveness of IRA, for example, with the changes in the 1986 tax reform package. If people have a pension, then they obviously can write off less of their contribution to an IRA account. And I've heard from many people about that, so it has discouraged investments in IRA accounts as well with that change.

Mr. GREENSPAN. I would agree. I think it has discouraged investment in IRA's. It's not clear that it has discouraged total saving because, remember, in order to increase total savings what you have to be able to argue about an IRA is that somebody, say, cut their retail budget; in other words, they spent less on Christmas and took those moneys and put them into an IRA account. That's a true increase in savings.

You have to show that consumption declined relative to income to get savings higher, not merely that you increased a particular pocket of liquid assets.

Representative SNOWE. Thank you very much.

Thank you, Mr. Chairman.

Representative HAMILTON. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Greenspan, I want to follow up on some questions put to you by Chairman Hamilton about how economic policymaking is going to be conducted.

In particular, I am concerned that you and the President don't seem to be talking to one another except through the newspapers. You testified last week, and then immediately we find stories reading, "Bush signals disagreement with the Fed. President Bush, indicating apparent disagreement with current Federal Reserve policy said yesterday the central banks should not be trying to slow economic growth because of a fear of inflation."

Another headline: "President Bush Cautioned the Federal Reserve Board Today Against Overreacting."

Another headline: "Bush's Hopes, Greenspan's Fears," again emphasizing caution.

And then one even goes so far as to say, "Now it is President Bush who has to do some reading of lips, those belonging to Federal Reserve Board Chairman Alan Greenspan."

First of all, would you agree that it is not a good state of affairs to have this apparent quarreling between the Chairman of the Fed and the President going on?

Mr. GREENSPAN. Yes, I would agree it is not a good state of affairs. But I would also suggest that there is far less here than meets the eye.

I have discussed economic policy with George Bush for a number of years. I know basically where he stands and what his philosophy is, and I have had occasion to speak to him relatively recently prior to his inauguration. I think the most important statement that he has made; namely, that there is very little difference between us, is really the operative statement.

As far as I'm concerned, and I'll put it this way, any two people discussing or thinking about economic policy almost invariably have differences, and that occurs within the Federal Reserve, the Federal Open Market Committee, and the Council of Economic Advisers. It will occur in any group within the White House discussing policies.

I would say if you use that as a standard, that the differences between the President and myself that currently exist, as best I can judge, approach the negligible.

Senator SARBANES. My concern is not so much that there may be differences—although obviously one can be concerned about that, given their substance and extent—but that this communcation is not taking place on a direct basis.

Now, the President said, "I haven't talked to Alan lately," and then made his statement, disagreeing sharply with the current Federal Reserve policy.

How recently have you and the President talked?

Mr. GREENSPAN. I think it was in December, if my recollection serves me. But I have access to the President when and if I need it, and I would certainly be available anytime he would like to speak with me. I don't for the moment, see any particular need to.

Senator SARBANES. Why isn't there a need, if there's going to be this differing between you in the press?

Mr. GREENSPAN. I grant you, Senator, I think that it would be best if discussions of this type did not occur through the press, but

I do think that whatever differences exist, and I think they are really quite minuscule, if at all, have been excessively exaggerated.

Senator **Sarbanes**. On the 9th, a week from Thursday, the President is going to speak to the Congress and make a major economic statement as we understand it. It would seem to me that before he makes that statement and charts the economic path he intends to follow, there ought to be consultation between him and the Chairman of the Federal Reserve, since you as Chairman have significant control over a large part of economic policy; namely, monetary policy.

Would you agree with that?

Mr. **Greenspan**. I am speaking with the Secretary of the Treasury on a continuous basis and other elements of the administration, and I suspect that when and if the time arises, I will be speaking with the President on such issues.

I have no concern about the issue of communication with President Bush.

Senator **Sarbanes**. And no concern about disagreements appearing in the press in this way?

Mr. **Greenspan**. I do have concern about that. As I said, I don't perceive them as issues of significant differences.

Senator **Sarbanes**. Tell me, how would the economy be able to grow at 3½ percent in 1989 while short-term interest rates drop 200 basis points?

Mr. **Greenspan**. You are referring to President Reagan's forecast.

Senator **Sarbanes**. Well, I'm really just asking a question.

Mr. **Greenspan**. Well, I would say that if you ask me technically is it feasible, it is feasible. Is it probable? No, it is not.

Senator **Sarbanes**. I take it you would not, in effect, construct that kind of projection and argue for its internal consistency; namely, a 3½-percent growth rate in the economy, coupled with a 200 basis point drop in short-term interest rates.

Mr. **Greenspan**. From the average. In other words, the crucial issue is what is the starting point, but I would certainly not want to argue that case.

Senator **Sarbanes**. So you would, in effect, say there should be a different set of projections, closer to being realistic.

Mr. **Greenspan**. For 1989?

Senator **Sarbanes**. Yes.

Mr. **Greenspan**. Yes, I would, Senator.

Senator **Sarbanes**. Given the importance that you've attached to deficit reduction, would you be opposed to any changes in the Tax Code which would cost us any significant amount of revenues?

Mr. **Greenspan**. It depends on whether it was offset on the expenditure side. I mean, per se, I am neither for nor against the issue of revenues, without discussing where it is offset. But clearly, anything which in total acts against reducing the budget deficit I think would be unfortunate.

Senator **Sarbanes**. Obviously it would cost you on the budget deficit, because if you didn't do it, the deficit would be reduced by that amount, assuming what you're doing on the spending side.

Whatever you do on the spending side is done. Now, would you undercut that or diminish it by a tax cut?

Mr. **GREENSPAN**. Senator, if you're saying, abstractly, without talking about constructing a total budget, if revenues were reduced and therefore the deficit was increased, would I be in favor of that? The answer is no, I would not.

But I would assume in the composition of any budget that is constructed and presented to the Congress, that there would be offsetting effects such that, overall, the budget deficit would come down. We still do, of course, have Gramm-Rudman-Hollings which will essentially drive the final outcome.

Senator **SARBANES**. Let me press you on this point. Let's assume that spending cuts are going to be made. That will reduce the deficit by the extent of the spending cuts.

I'm now addressing whether you would then diminish the extent of the deficit reduction by supporting tax cuts.

Mr. **GREENSPAN**. It depends—there are two questions here. One is—and I assume you are referring to capital gains tax.

Senator **SARBANES**. No, I'm not. I'm just asking a very straightforward question on how important you regard deficit reduction and whether you regard it as of sufficient importance that you would preclude loss of revenues as a policy.

Mr. **GREENSPAN**. Sure.

The answer is, in general, yes. The reason I raised the capital gains tax question is that that is a tax cut which doesn't necessarily mean a loss in revenues, depending on who is going the calculation and what type of cut it is.

Senator **SARBANES**. But if you lose revenues, are you against it?

Mr. **GREENSPAN**. I would tend to be against it, other things equal. Yes.

Senator **SARBANES**. Mr. Chairman, could I put just one final question?

Representative **HAMILTON**. Yes.

Senator **SARBANES**. There has been some suggestion, in fact appearing in a letter of one of the Federal Reserve regional banks, that one of the factors in the productivity slowdown, which we are very concerned about, is the deterioration of our public infrastructure. When we look at other countries which seem to have good productivity performance, we find a much higher rate of investment in infrastructure, suggesting a relationship between investment in public infrastructure and productivity.

Do you accept those propositions?

Mr. **GREENSPAN**. Well, I've found them sufficiently interesting to ask for an internal evaluation by the Board staff on that particular study, and I think that there are some questions about the statistical analysis.

Senator **SARBANES**. Thank you, Mr. Chairman.

Representative **HAMILTON**. Congressman Solarz.

Representative **SOLARZ**. Thank you very much, Mr. Chairman.

Mr. Greenspan, I apologize for not being here sooner, but we were having an organizational meeting of the Foreign Affairs Committee.

We have all heard over the years about the importance of reducing the deficit, and yet I assume you would probably agree that one relative measure of the significance of the deficit is its relationship to the gross national product.

My understanding is that the deficit is now running about 3½ percent of GNP, which seems to be well within the historic range of the deficit as a percentage of the gross national product.

I am also under the impression that most of the other industrialized democracies in the world have deficits which are more or less in that range as well.

If that is in fact the case, how concerned should we be about the deficit, given the degree to which it is declining as a percentage of the GNP and seems to be within the historic range that it has been in the past?

Mr. **Greenspan**. We have to be quite concerned because, unlike some of our trading partners who have deficits not significantly differeent, as a percent of the GNP, to that of the United States, we don't have adequate domestic savings to finance it.

If we, for example, had two to three times the rate of domestic savings, as indeed some of our major trading partners have, I would think the 3 percent Federal deficit would not be a significant issue. It would be relatively easy to finance, not a significant deterrent to net domestic investment, and something which would be an issue more related to Treasury financing than fundamental economic stability.

The issue I think is best stated as the deficit relative to domestic savings, and there we fail.

Representative **Solarz**. To what extent does the infusion of foreign investment, which has been rather substantial in the last several years, compensate or even more than compensate for the shortfall in domestic savings?

Mr. **Greenspan**. It compensates a great deal. In fact, had we not had that coming in, our recent rather low level of net domestic investment would have been even lower and could conceivably have been negative.

So it's been a help, but the problem that we have is we cannot assume indefinitely into the future that foreigners will continue to be willing to ship their savings to the United States for American investments. If we could, and we were certain it were to occur indefinitely into the future, I would be less concerned.

But I must say to you, I don't have that sense of tranquility about such an issue.

Representative **Solarz**. Under what circumstances might you envision a significant decline in foreign investment in our country?

Mr. **Greenspan**. It comes from either of two sides. Obviously, if we reduced the trade deficit and the current account deficit, that automatically does it. But I think the question really is, given our existing trade accounts and our trade relationships, if there is a spontaneous reduction in the propensity to accumulate U.S. dollar investments—which is another way of moving the savings into the United States—is that a big problem? And the answer is yes; it could be a very significant problem.

Representative **Solarz**. And what might precipitate that spontaneous withdrawal from dollar-denominated assets?

Mr. **Greenspan**. Any of a number of things, the major one being a loss of confidence in the policies of the United States and the stability of the United States.

Representative **Solarz**. If our dependence on foreign investment as a way of compensating for the relatively low-savings rate in this country is ultimately the result of the fact that we do have not only a low but a declining savings rate, it would appear that that is a critical component of the problem we face.

I wonder if you could share with us your thoughts as to why the savings rate, first, has been declining; second, why it is as low as it is, particularly relative to other industrialized countries; and, third, what thoughts you might have about what we can do, if anything, to significantly increase the domestic savings rate, particularly with respect to private savings because the answer with respect to government-induced savings is fairly clear—we just have to reduce the deficit.

If you could elaborate on those dimensions of the problems, I think it would be helpful.

Mr. **Greenspan**. First, Congressman, it's not something indigenous to the long-term culture of the United States. Indeed, from the post-Civil War period through the 1930's savings in the United States relative to that in the European and Asian countries was higher. In fact, we were probably the highest saving country in the world. That's how we got our standard of living to where we eventually emerged.

Representative **Solarz**. Can you provide those precise figures for the record, Mr. Chairman?

Mr. **Greenspan**. Certainly.

"Precise," however, is something I would want to question.

Representative **Solarz**. Well, whatever you have.

Mr. **Greenspan**. We do have numbers, and we will be glad to do so.

[The following information was subsequently supplied for the record:]

The Federal Reserve Board staff has compiled evidence drawn from various published sources on national saving rates for several countries since 1870. Differences across countries in the definition and collection of data are such that these figures are only roughly comparable, especially before World War II. According to a standard accounting identity, national saving is equal to the sum of gross domestic investment and the current account surplus. The following table presents estimates of saving rates based on national data on investment and the balance of payments, which are somewhat more accurate than direct measures of saving.

SAVING-GNP RATIO
(decade averages in percent)

	United Kingdom	Germany	Italy	Japan	United States
1870-79	11.9	n.a.	8.0	n.a.	18.2
1880-89	10.9	12.7	9.8	n.a.	17.6
1890-99	10.3	15.0	9.3	14.4	20.0
1900-09	11.8	16.0	15.8	13.1	19.3
1910-19	7.8	n.a.	3.7	21.0	16.8
1920-29	10.9	n.a.	12.8	16.6	17.0
1930-39	8.3	6.2	15.7	19.9	8.5
1940-49	1.7	n.a.	9.7	24.0	11.6
1950-59	14.8	25.4	18.6	28.2	16.3
1960-69	17.0	28.1	20.6	36.5	16.1
1970-79	18.9	24.4	22.5	35.2	16.4
1980-85	18.1	21.2	18.9	30.8	14.7

Mr. **Greenspan**. The problem exists in the post-World War II period generally when American savings begins to fall relative to those of our trading partners. Perhaps it was a change in culture. Clearly there is an increased propensity to consume and take on debt.

The United States, for example, has been one country in which home ownership has been debt driven and we've made tremendous investments in housing so that until very recently, as you know, home ownership has risen very extraordinarily and has been a major boon to the American public.

But it has carried with it a general willingness on the part of the public to accumulate debt rather than to save in advance to buy a house. And it has largely been that element of debt, the willingness to take on debt which has been, as I see it, the major factor leading to a deterioration in savings.

In recent years, there has been an artificial problem also related to debt, in that the tremendous increase in the market value of existing single family residences has, as they have turned over, increased mortgage debt by close to $100 billion a year, as people sold existing homes and the purchasers took on higher debt.

The individuals who sold the homes have a large capital gain and they don't perceive themselves as dissavings, and the people who buy the houses don't perceive of themselves as dissaving, but because we do not register the realized capital gain as a plus to savings, but do subtract the increase in the mortgage debt which financed it as a reduction, our savings rate as published is somewhat lower than what people feel their savings are.

Representative **Solarz**. Given these considerations and factors, let me conclude by asking you what, from a policy point of view, you think we can do to encourage a significant increase in the savings rate.

Mr. **Greenspan**. I have puzzled that over the years and have been drawn more or less to various types of tax credit schemes such as the IRA and other initiatives.

I must say that regrettably, looking back over that period, we've had very little success. I am, as I've said in other congressional hearings recently, looking at that issue in some detail, hoping to find some handle on improving this.

I must say to you, Congressman, I have not been successful, at least in my own mind, in devising schemes other than certain radical changes such as going from an income tax to a consumption tax which I think is probably not, in the political environment, even remotely feasible.

But, having said that, I then come back to the point that you made earlier; namely, that that leads us to the conclusion that we have to get the Federal budget deficit down and hopefully even into surplus, because it's only by that mechanism that I believe we can materially increase total domestic savings.

Indeed, I would say it is imperative on the part of the United States if we are going to increase investment so that we can increase productivity and efficiency in this country and compete in the world as we choose to do.

Representative **Solarz**. Thank you very much.

Representative HAMILTON. Mr. Greenspan, one of the shocks to the American economy this year and last has been the S&L crisis. I want to go into that with you in a little bit.

But first, do you see any other shocks coming down the road for the American economy comparable to that?

Mr. GREENSPAN. I certainly hope not. I know of nothing on the immediate horizon that strikes me as anywhere near the type of problem that that has created for us.

Representative HAMILTON. Now, one of your responsibilities, of course, is to try to preserve the integrity of the financial system. You've been moving at the Fed to push up interest rates.

What kind of an impact is that going to have on the health of the S&L's?

Mr. GREENSPAN. It works in two directions, Mr. Chairman. Clearly, strictly looking at the arithmetic and bookkeeping of interest costs, higher short-term interest rates obviously increase the cost of short-term funds to savings and loans.

However, if one envisages a policy which had not been doing that, a policy which would allow inflationary pressures to emerge, it is quite likely that the negative effects on S&L's through higher inflation and interest rate increases because of that would have been far more deleterious.

So, obviously, in implementing monetary policy, the Federal Reserve must weigh the impact of such things as what happens to the thrifts, but it's been the judgment of the Open Market Committee that the costs of not doing something would have been far more negative to the thrift problem than moving as we did to move up short-term rates in 1988.

Representative HAMILTON. Do you favor decreasing the amount of deposit insurance?

Mr. GREENSPAN. No, I do not. I think that there has to be a major review of the whole deposit insurance issue, but I don't think that much is gained by reducing the $100,000 insurance limit.

Representative HAMILTON. The FDIC Chairman, Mr. Seidman, suggests that the Home Loan Bank Board not only regulates the industry but promotes it. And he finds a basic conflict there among the goals.

Do you agree with that criticism?

Mr. GREENSPAN. I don't know if it's a criticism. I think it's one of the original purposes of creating the Federal Home Loan Bank System. It does promote, and is supposed to promote, the thrift industry, and in that respect there is an element of conflict between——

Representative HAMILTON. Did that play a role in the crisis that we now confront on the S&L's, the fact that you have the Home Loan Bank Board with two functions here?

Mr. GREENSPAN. It's awfully difficult to know. Clearly there is a potential conflict between the subsidization actions on the part of the Federal Home Loan Banks on the one hand and the insurance functions of FSLIC on the other. Whether that potential actually materialized into a problem, I frankly cannot say.

Representative HAMILTON. The paper reports this morning that President Bush is getting ready to recommend to us a lower capital gains tax rate. You talked with Senator Sarbanes about this to some extent.

Is there evidence that shows conclusively that a lower tax rate on long-term capital gains will result in an increase in business investment in plant and equipment?

Mr. GREENSPAN. I think the evidence, which is very difficult to filter through because of the complexity of it, does suggest that lower capital gains tax rates do enhance the creation of investment and expansion, specifically in entrepreneurial-type businesses.

Representative HAMILTON. Is it your judgment that you would get more revenues with a reduction in the capital gains rate?

Mr. GREENSPAN. More revenues?

Representative HAMILTON. Yes. Would it increase revenues?

Mr. GREENSPAN. It depends on from where it starts and to where it goes. Obviously, if you go to zero, you won't get very much in capital gains taxes.

Representative HAMILTON. Well, he wants to cut it to 15 precent. How's that?

Mr. GREENSPAN. I frankly don't know the answer to that, Mr. Chairman. I do know that the assumption that it automatically loses revenues is as difficult to sustain as that it gains revenues.

Representative HAMILTON. Would a lower capital gains tax rate or a lower Federal deficit have a greater impact on business investment in plant and equipment?

Mr. GREENSPAN. I'd like to see both.

Representative HAMILTON. And if you can't see both, and only see one?

Mr. GREENSPAN. I'm not really in that position to make that choice, Mr. Chairman.

Representative HAMILTON. Would you be willing to trade a lower tax rate on capital gains for higher marginal tax rates, as some have suggested?

Mr. GREENSPAN. No, I wouldn't, because I thought that as much as I disliked the increase in the capital gains tax rate in the 1986 act, the tradeoff toward the lower marginal rate was a desirable one, and I would not like to see that reversed.

Representative HAMILTON. How do you feel about the proposals that probably are going to be coming at us here? President Bush has indicated he wants tax credits to help low-income parents on child care. He wants tax-free savings accounts for people to set aside for college expenses, and maybe lower taxes for enterprise zones in poor neighborhoods in the big cities.

Now, all of those proposals kind of erode the premise and the theory of the 1986 bill, don't they? How do you feel about that?

Mr. GREENSPAN. The only thing I know about these is what I've been reading in the newspapers, Mr. Chairman.

Representative HAMILTON. That's all I know.

Mr. GREENSPAN. Well, I would just as soon wait to see what the President proposes before I presume that he's going to make a presentation based on what I read in the newspapers.

Representative HAMILTON. Well, that's fair enough.

Senator SARBANES. Mr. Chairman, could I just interject on your time?

Representative HAMILTON. Yes, Senator Sarbanes.

Senator **Sarbanes**. I think that's one of the problems. I really disagree that you, as Chairman of the Fed, should simple wait and see. I think the administration needs to be talking with you, because we can't set an overall, rational national economic policy without coordinating your fiscal and monetary policy.

I assume you would agree with that.

Mr. **Greenspan**. I do agree with that.

Senator **Sarbanes**. OK.

But to have you sit here and say that all you know is what you read in the paper, and that you'll just have to wait and see seems to me to reflect right here from the outset a basic weakness in the kind of consultation that should be going on amongst the major economic policymakers.

Mr. **Greenspan**. I have been involved, Senator, on virtually all of the areas which are crucial to economic policy. This particular issue I have not discussed with anybody. I would suspect that if—and I quote the word "if"—it is an initiative that will appear in the presentation by President Bush, I will have a crack at it well in advance.

All I'm saying with respect to this particular issue is that I have not discussed that particular part. The budget that is being put together by President Bush is in the works at this stage. I assume there are innumerable things in that budget of which I am, at the moment not aware, but will be prior to his moving forward with it.

Representative **Hamilton**. Senator Gore.

Senator **Gore**. Thank you, Mr. Chairman.

Let me say that I have very much been looking forward to joining you and our Vice Chairman, Senator Sarbanes, as a member of this Joint Committee, and I appreciate the testimony you have provided, Mr. Greenspan.

I was here for your full statement this morning, but I had to leave before my round of questioning, and I know that my colleagues have asked many of the questions that were going to be on my agenda, so I only have a few here toward the end of this session.

In your statement you talked about reasons for concern about the future course of the economy in the near term, and you talked about resource utilization rising to levels that, at numerous times in the past, had been associated with the worsening inflation.

Are you referring there primarily to employment levels and capacity utilization?

Mr. **Greenspan**. I am referring basically to the unemployment rate and, more importantly, to a more disaggregated unemployment rate which we had put together and called the natural unemployment rate, which basically reflects where inflationary wage pressures tend to build, and—what I would call more important than the issue of capacity utilization—deliverability.

By deliverability, I mean the capability of a company to meet its orders in a timely manner. It can do so either because it has its own domestic facilities or can import or have other means of getting goods, such that the leadtimes on the deliveries of the materials which it ships to its customers are not expanding.

It is usually the period when leadtimes are stretching out or delivering delays are mounting that inflationary pressures tend to become difficult to contain.

Senator Gore. All right. Let me explore one of those factors a little bit more.

You talked in your statement about the disaggregation of employment figures to make up the so-called natural rate of employment, and you explored that a little bit. But in December, the civilian unemployment rate as we now measure it fell to 5.3 percent, the lowest level since May 1974.

How close is that to what used to be called the full employment-unemployment rate?

Mr. Greenspan. Well, the natural rate is very close in concept to the full employment-unemployment rate. In fact, we try to define it in a manner which essentially says at what unemployment rate, if we begin to move below, do we create an acceleration in the rate of inflation? And that essentially is what the concept usually means.

I don't know exactly where that number is. There are some who are estimating it as low as 4½ percent. There are others who are saying we're already well below it. My impression is that we are in the vicinity, but it's very difficult to make a judgment as to whether it is higher or lower.

Senator Gore. I wasn't on this committee a year ago, but I know that you testified then, at a time when it was 5.7 percent, that you thought it could decline less than a percentage point more from that level.

You said, and I quote, "My impression is that it's closer to a half, maybe even somewhat less than that, without triggering an unacceptable acceleration in wage and hence, inflation cost."

Now, since that point, it has declined 0.4 percent. Do you want to leave us with the impression today that you think we're right on the cusp of the point where that factor is going to begin generating enhanced pressures?

Mr. Greenspan. I don't know very much more than I did a year ago, Senator, and I will stand by what I said back then; namely, that somewhere closer to 5 percent is where that rate is.

My impression is that the evidence probably pretty much confirms what I was discussing about a year ago, that we've had some marginal edging up, and therefore we're not all that far from it. But I cannot say to you I know that it's this specific percent.

Senator Gore. OK. Let me shift to another subject that I don't think has been explored with you. If it has been, then I'll back up and do it a little different way.

Under your chairmanship earlier on, the National Commission on Social Security Reform recommended a number of changes in Social Security that assure the financial solvency of the system for the next 75 years, given the assumptions that most of us work with.

Since then, you have nonetheless recommended, as before the Senate Budget Committee 10 months ago, that Social Security and other entitlement programs "offer substantial opportunities for long-term budgetary savings."

Do you still recommend that? And with Social Security currently running an annual surplus in the range of $50 billion, what would be the purpose of cutting Social Security benefits?

Mr. **Greenspan**. Senator, I'm not recommending that Social Security be cut. As I think I was at that time, I was merely looking at the sources of potential cuts in outlays, and I mentioned entitlements generally and was looking at a variety of different alternatives.

However, leaving aside whether or not one wishes to increase or decrease benefits—and I think one can argue on both sides of that question—the size of the surplus is not a relevant consideration in the sense that what we have not been able to do, and what the Social Security Commission just did in part, is move the system toward full finding. We're still far from full funding, and it's still the case that we are not yet in a position where one can say that over the very long term, we have a fund which will finance benefits beyond the middle of the next century.

It is obvious that one of the reasons why we recommended this buildup is that when we looked at the demographics, we just found no other way to confront that very major problem out in the year 2030 and beyond without developing this surplus.

But I don't think that this surplus in and of itself is really relevant to whether or not benefits should currently be higher or lower.

Senator **Gore**. There are several questions involved there. Obviously, we need to build up the surplus in order to take care of the sudden phase change in the ratio of persons retired to persons working when the baby boom generation reaches retirement age.

But during the time—I mean just as the demographic changes mandate adjustments in government programs that are sensitive to that demographic wave, so fiscal policy and budget policy are in turn affected by the large wave that comes out of the Social Security system.

Now, I agree with and support your recommendations that were adopted on building up that surplus in order to take care of the demographic wave. Now, in the meantime, before we get to that transition point when we go from one phase to another and we stop building up the surplus and start drawing it down, how is the budget and fiscal policy affected by that wave?

While this large surplus is being built up, what adjustments ought to be made in your view? Do you have the view that the rest of the budget should be in balance while that surplus continues to grow?

Mr. **Greenspan**. I am not one who is arguing in favor of separating the Social Security trust funds from the budget. Even though that was a recommendation of the Commission which I chaired, I was one of the negative votes on that recommendation.

The basic reason is that I think we best manage fiscal affairs by looking at the so-called unified budget in total. While it is interesting and in many cases instructive to separate the various trust funds, I don't think it helps overall policy.

Very specifically, I'm not in favor of the break because a very large part of the Social Security surplus increase is accumulated interest, and that accumulated interest is interest payments on the funds of the Social Security system. That interest payment rises to approximately 1 percent of GNP after the turn of the century.

If we split the budget into two parts, Social Security trust funds on the one hand, and all other, the "all other" has to pay that interest. In fact, the Treasury department budget pays that interest into the Social Security trust fund, which I might add, in the unified budget, washes out. It's an intragovernmental transfer.

But that very sharply rising interest payment becomes an outlay in the non-Social Security part of the budget, and that will make it extraordinarily difficult to keep that part of the budget deficit down.

I think the Congress will probably find it far easier to view the system combined, largely because the huge surplus in the Social Security trust fund will be, in large part, a reflection of that intragovernmental transfer, so we'll have a burgeoning surplus coming in one part of the budget, a burgeoning deficit coming in the other part, merely because of that intragovernmental transfer.

I think that there is a problem involved in fiscal policy as we get into that big bulge in the Social Security trust fund, but I think it is perhaps best handled if we were to look at it in a combined sense and try to manage our fiscal affairs in total and try not to think in terms of Social Security on the one hand and non-Social Security on the other. From an economic point of view, a fiscal point of view, I don't think it's a useful concept.

I must say to you, Senator, I am in a minority on this issue.

Senator **Gore**. I understand that.

What you say raises a lot of other questions. My time has expired, and I hope we can pursue them in another meeting or in another context.

But just to follow up very briefly on a final point here, however you deal with the so-called unified budget issue, would you recommend that the other parts of the budget be in balance while that surplus exists? In other words, if you look at the total, do you recommend that the rest of it be in balance while that surplus is being built up?

Mr. **Greenspan**. Frankly, Senator, I would because that would create——

Senator **Gore**. You would?

Mr. **Greenspan**. Yes. That would create a large budget surplus on a consolidated account in the unified budget.

Senator **Gore**. Very large.

Mr. **Greenspan**. Well, the trouble with dollar figures is that when you begin to project them 10, 15 years out, everyone is making $50 an hour, and the whole dimension is different.

It is a large surplus. I do grant you that. I think I would certainly try to keep part of that, perhaps most of that surplus, and not have it offset by the other part of the budget because I do think, however one looks at these data, that a unified budget surplus for the United States in the latter part of this decade and in the early part of the 21st century would be very helpful.

Senator **Gore**. Thank you very much, Mr. Chairman.

Representative **Hamilton**. I indicated to Chairman Greenspan that we'd try to conclude by noon, so we'll split the remaining time between Congressman McMillan and Senator Sarbanes.

Congressman McMillan.

Representative **McMillan**. I'll try to be brief.

I agree that the Chairman of the Federal Reserve and the President should be in frequent dialog, but I do think it's appropriate to point out that the new President has only been in office for some 6 working days, and in order to have had much dialog, you would either had to do it at inaugural balls or at Lee Atwater's rock concert, which may not be the appropriate place to discuss these weighty issues.

Mr. **Greenspan**. Can I just respond to that, Congressman McMillan?

Representative **McMillan**. Yes.

Mr. **Greenspan**. I must say I agree with that. I think there's been an unfortunate exaggeration of this thing. I have no problem in communicating with President Bush. He is a very old acquaintance of mine. I used to visit him quite often. I intend to visit him quite often. I feel no deprivation of communication.

While it may appear that we are somewhat at odds, he is the President of the United States, he can and should say what he believes about things, he certainly can tell me, and will, and I think that's a very useful and constructive dialog.

I'm not the least concerned about what's going on. My only concern is that I think the press has tried to make sort of a cause celebre when none exists.

Representative **McMillan**. I would agree. Six months from now that might be a problem.

Mr. **Greenspan**. It may be, but it is certainly not now.

Representative **McMillan**. No, I'm not projecting that it will be. I don't think it will be.

But let me follow up a line that Sentor Gore ended up on. If in fact let's say we had a budget balance and the surplus building, which should be building in the Social Security trust fund, were in effect from an economic standpoint, a surplus that could, on a net basis, reduce the indebtedness of the United States except to itself, would that not then constitute a dramatic increase in the savings rate in this country? Or would it?

Mr. **Greenspan**. I'm sorry. Give me that again, Congressman McMillan?

Representative **McMillan**. I guess to simplify it, would a surplus generated in Social Security constitute savings in the economic sense?

Mr. **Greenspan**. The anwer is yes, if it is not dissipated through other elements of the Federal budget.

Representative **McMillan**. I understand that.

I'm saying assume the scenario that he stated. That is, you have a balanced operating budget, if you will, but Social Security is accumulating and continuing to build.

Mr. **Greenspan**. In that case, yes. Under those conditions, yes, you're quite correct.

Representative **McMillan**. That would then be a rather dramatic rate of savings, woult it not?

Mr. **Greenspan**. Yes, it certainly would. And it would solve our domestic saving problem.

Representative McMillan. I think in the minds of the American public who are out there paying their employment taxes, Social Security is perceived as savings, whether or not economically it's been managed in that respect.

Mr. Greenspan. Yes, I would agree with that.

Representative McMillan. And, somewhat related to that, you on the question of home ownership and the buildup of home equity, either through direct cash contributions to that or appreciation in market value, do we count the direct contribution or the equity buildup as savings in this country?

Because I think there again, in the perception of the average American family, because of the way real estate values have been for the most part stable to rising in this country, home ownership is viewed as a primary means of savings.

Mr. Greenspan. Yes. The net equity that people put into their homes is counted as savings. The realized capital gains that are involved in the sale of existing homes are not included.

Representative McMillan. I understand. Thank you.

One other point I'd like to raise, and it may bear some further investigation at another time. Given the tremendous increase in the growth of the service economy in the United States, do we have adequate measures of productivity that are valued in a total economic sense when we characteristically have tended to view productivity as a manufacturing activity that reduces quantifiable outputs?

With the resources that we put into medicine, which is again one of the inflation-impacted segments of our economy, legal services—we could go on and on—do we have adequate measures of productivity? And, somewhat related to that, has to do with the capital investment because a lot of the capital investment in this country goes into the support of the service sector without very adequate means, it would seem to me, of measuring that capacity utilization.

Mr. Greenspan. It's always been a very serious problem of how to measure productivity in certain services. We don't have problems, for example, in measuring productivity in electric power output service because we can measure the output with some degree of accuracy.

Similarly, in telecommunications, we're learning how to get message unit measures so that we have a unit of output which is a numerator of all productivity measures.

But when we get into some of the more advanced computer software services, where defining what constitutes the unit of output is problematic, we are having increasing difficulty. Obviously, as you pointed out, measuring the productivity of physicians, of hospitals, of the whole medical structure, is not easy because the unit of medical service is changing so dramatically that merely to say how many days did one spend in a hospital as a unit of production in 1988 versus 1968 is wholly missing the extraordinary changes in technology and deliverability of services that occurred between those 2 years.

I think we probably underestimate the gross product originating in services as a consequence, and hence productivity and productivity growth. But it is very difficult to get your hands on that because conceptually, the data are not helpful, and I think we are going to have to deal with this type of problem indefinitely into the future.

Representative HAMILTON. Senator Sarbanes.

Senator SARBANES. Mr. Greenspan, I just want to make one observation in response to Congressman McMillan's observation. George Bush was elected President on November 8, so there's been an extended period of time when he could have had discussions with Chairman Greenspan who has been in place as Chairman of the Federal Reserve for some time. So it's not a matter of doing it at the inaugural balls, and I think it's a pretty serious matter.

I am deeply concerned that the new administration is developing its economic game plan, and that the Chairman of the Federal Reserve has not been in consultation with the President, and that in fact they're expressing differences in the public press.

The question I want to put to you, Chairman Greenspan, is: If you were developing a deficit reduction program absent the current framework or constraints in which we are doing it, what would be the magnitude or the dimensions of that program?

Mr. GREENSPAN. I'm sorry. I missed your question because of the buzzer.

Senator SARBANES. if you were developing a deficit reduction program, absent the constraints and framework in which we're now addressing it, what would the magnitude and dimensions of that program be?

I take it first of all from your earlier answers, they would be multiyear. You regard that as extremely important.

Mr. GREENSPAN. I would say indispensable.

Senator SARBANES. I agree with that.

Now, what would the magnitude of it be?

Mr. GREENSPAN. I think that the numbers that are currently in the Gramm-Rudman-Hollings projection are as good as we can get. I'm not concerned about fiscal drag, for example, that is, of overdoing the reduction largely because, as I mentioned earlier, Senator, should we get a credible, sharp reduction in the deficit and that reduction was perceived of as withdrawing purchasing power from the system and being excessive, I think that real long-term interest rates would fall appreciably such that private effective demand would be galvanized in a manner to offset any negative economic pressures from moving the deficit down too rapidly.

I'd be more inclined to move the deficit down as quickly as is politically feasible. I would say, for example, if I would take that as the criterion, that the Gramm-Rudman sequence of budget reductions is roughly within that realm.

Senator SARBANES. So how much would you set out to reduce the deficit in the coming budget?

Mr. GREENSPAN. Assuming we're starting at, say, $161 billion for fiscal 1989, I would aim, as in fact Gramm-Rudman does, at $100 billion which is the goal, but would be willing to accept, say, $110 to $120 billion as a major improvement and one which would have very useful impacts on the financial system.

Senator SARBANES. Would you want a bigger reduction?

Mr. GREENSPAN. Yes, I would like to see a bigger reduction.

Senator **Sarbanes**. Would you like to see a reduction of $150 billion? Would you like to see, as an economic judgment, an effort to eliminate the deficit in 1 year?

Mr. **Greenspan**. I think that is highly hypothetical. It really is a hypothetical question because I know as a practical matter it is not something which I will ever be tested upon.

I think it's probably wiser to split it in two. I would feel a little more comfortable if I literally had that configuration of 75 and 75. But if I were forced, no change——

Senator **Sarbanes**. If you were establishing a multiyear deficit reduction program, over what period of time would you envision having this multiyear program?

Mr. **Greenspan**. Three or four years.

Senator **Sarbanes**. So you would take a $160 billion deficit and project that over a 3-year to 4-year period you would eliminate it?

Mr. **Greenspan**. Yes.

Senator **Sarbanes**. Thank you, Mr. Chairman.

Representative **Hamilton**. Mr. Greenspan, we may have a few questions to submit, and if we do we will be in touch with your office very quickly.

We thank you for your testimony, and the session stands adjourned.

[Whereupon, at 12:05 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1989 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 2, 1989

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 10:09 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Solarz, and McMillan; and Senator Gore.

Also present: Joseph J. Minarik, executive director; Robert J. Tosterud, minority assistant director; and William Buechner and Dale Jahr, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative **Hamilton**. This morning, the Joint Economic Committee continues its hearings on the economic outlook for 1989 and the 1989 Economic Report of the President.

The focus of today's hearing is on the outlook for the economy during 1989 and 1990. We are pleased to welcome three highly regarded forecasters before the Joint Economic Committee this morning to discuss the economic outlook, including Lawrence Chimerine, chairman and chief economist of the WEFA Group; Richard Rahn, vice president and chief economist, U.S. Chamber of Commerce; and Allen Sinai, chief economist of the Boston Co.

And we also hope to address the issues, including the deficits for fiscal year 1990 and the years beyond, the outlook for employment and unemployment, the impact of rising interest rates on the United States economy and our trade balance, and the impact of economic conditions and economic policies in Europe, Japan, and the rest of the world on the United States economic outlook.

We will turn now to our witnesses, who will talk about the economic outlook and economic policy.

Mr. Chimerine, please proceed.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN, CHIEF EXECUTIVE OFFICER AND CHIEF ECONOMIST, THE WEFA GROUP

Mr. **Chimerine**. It is good to see you again, Mr. Chairman. I don't know if I should offer my congratulations or sympathy on your role as chairman of this committee at this very difficult time with respect to the economy and economic policy.

You have allocated 10 minutes for me, so I don't think I can cover all of the issues you specified in my oral presentation.

Let me focus on two things, therefore, and then we can get to the rest of the subjects in the discussion period thereafter.

First, I'll provide a brief summary of the economic outlook as I see it for the next year or two and then, second, I will focus on some of the key policy issues, including the budget deficit, trade, and so forth.

I don't think there's any doubt that the economy continues to hold up fairly well; based on my examination of the data as well as feedback we get from our clients, the expansion is still intact. The economy outperformed expectations, at least for most of us, in 1988 and it has started 1989 on a reasonably firm footing.

One of the most interesting aspects of the economy in the last couple of years is that, while we have continued the overall expansion, the sectoral mix has shifted, so that the recovery is now being led by strong exports and capital spending, whereas, during the first 4 years of the expansion, it was consumer spending, defense, the service sector, and construction which led the way.

Those are not quite as bouyant now as they were before, but the manufacturing sector obviously has picked up dramatically as a result of the upturn in exports.

And that pattern seems to still be in place.

My view is that the recovery will continue in 1989 and 1990. We do not see recession during this period as the most likely outcome. But economic growth is slowing somewhat from what it was earlier. First, export growth has slowed down somewhat.

It is very difficult, if not impossible to continue the 30 percent rate of increase in exports that we had in 1987 and early 1988. That is slowing somewhat, and I think that process will continue for the next several years. And even though consumer spending ended 1988 on a strong note, it is now growing more slowly than it did early on in the recovery. And now construction is sluggish for most categories and in most parts of the United States.

And, as I mentioned a moment ago, the military buildup is flattening out. These factors have taken some of the edge off of economic growth, so that I expect GNP growth in the 2 to 2.5 percent range for both 1989 and 1990.

I think we will avoid recession because backlogs are still quite high, because the increase in interest rates thus far has had only a small dampening effect on the economy, and because inventories are in good shape. Thus, for these and other reasons, my best guess at the moment is that the expansion process will continue, but it will continue at a somewhat slower rate during the next few years than we have seen over the last several years.

I think it is extremely important to focus on why the economy is doing as well as it is. In looking both at 1989 and 1990, as well as the long term, the key issues are the policy issues that will impact long-term economic performance rather than just the outlook in 1988-89 and 1990.

And what concerns me is that some of the forces that have perpetuated this recovery, in my judgment, are somewhat temporary in nature.

This is one of the main reasons why I think the rate of economic growth will taper off. First, the economy's ability to absorb more and more debt is absolutely incredible and unprecedented. Some of that debt, of course, is being used to fund financial transactions, some of it to finance new spending.

At some point, this will diminish.

Second, much of that debt buildup is being funded from overseas and I don't think there's any reason to believe that this will continue on indefinitely.

Third, productivity growth, in my judgment, has been disappointing. It is slowing down again.

Much of our recent economic growth has come about because of increased employment. But we are running out of more and more bodies to put out into the labor force and put into new jobs.

Thus, if you look at the underlying fundamentals, there's no question in my mind that the most prudent assumption to make about economic growth in the future in this country is that 2 to 2.5 percent is about the best we are going to do, unless for some reason we see a dramatic acceleration in productivity.

And my reading of the numbers suggests that in the last year or so, despite the economic growth overall, we are going in the wrong direction. Productivity growth seems to be tapering off back toward the trend of approximately 1 percent a year that has prevailed since 1973.

So, from the supply side of the economy, slower growth in the labor force, and in productivity, cutbacks in capacity in a number of industries such as steel and other commodity industries—which are limiting the improvement in our trade deficit—all suggest slower economic growth. And, when you look at the demand side, the slow real income growth, and the unlikelihood that we can continue to build up debt as quickly as we have, I think a prudent assumption to make both in the near term and the long term is that we are now entering a period of significantly slower economic growth.

Thus, the fastest period of economic growth we're going to get in this phase of our history has already taken place over the last 5 or 6 years.

I think the key question, Mr. Chairman, is what do we do to perpetuate this expansion and make sure that we get at least 2 to 2.5 percent?

And even more importantly, what can we do to accelerate that on a long-term basis?

And that gets into the entire issue of appropriate economic policy.

I would like to focus on two areas in particular. One is trade and competitiveness, the other budget deficit. And I will try to conclude my remarks then.

I probably have been more concerned about our competitive problem in this country than most other people. I think we have a serious problem of fundamental competitiveness.

By and large, I believe that we have lost most of the competitive advantages that enabled us to dominate the world economy for so many years.

We were far ahead of everybody else in technology. Average productivity levels in the United States in almost every single industry, going back 10 or 20 years ago, was far higher than it was in other countries overseas.

Product quality was higher in the United States than elsewhere. And I think, if you make an accurate assessment of the information that is available, those competitive advantages have either been diminished and, in many cases, have actually disappeared completely, and despite all the other explanations of trade deficits, such as the overvalued dollar in the early 1980's and our high budget deficits, and such as our faster economic growth which caused us to suck in imports, and all of the other explanations—all of which are true at the margin—the real problem is the problem of competitiveness.

And in my judgment, there has been a dramatic deteriorization relative in the competitive position of the United States in world markets in the last 10 or 15 years.

I have sensed some complacency recently because the trade deficit has turned a little bit, and because manufacturing has picked up. And because we have some pickup in productivity, at least over the last 2 or 3 years.

So a number of people have argued that, even if we did have a problem, it is not that serious any more.

I fundamentally disagree with that conclusion for a number of reasons.

First, the trade deficit has improved, but it is still incredibly high. I doubt this country can live with a $130 or a $135 billion trade deficit on an ongoing basis. I don't think it can be financed.

And, as you know, over the last 6 months, it seems to have stalled out at that level.

Second, I don't see the productivity improvement that we have obtained over the last several years as being permanent and ongoing. A significant amount of it reflects one-time adjustments that have taken place in the corporate sector, such as plant closings, when the least efficient plants were being shut down; such as corporate staff layoffs; such as job outsourcing from manufacturing to the service sector. Much of the improvement in manufacturing productivity we have obtained, reflects these one-time adjustments and are not likely to show up as ongoing, continuous growth in productivity.

As I said earlier, if anything, we have already seen it slow down. And, furthermore, the Japanese and our other competitors are not standing still.

So we have not really narrowed the gap with some of our foreign competitors because their productivity growth has been quite rapid during this period as well.

In addition, by our calculations, 90 percent of the improvement in exports and the decline in the trade deficit over the past 2 years has come about because of the weaker dollar and because of corporate cost cutting, rather than because of any major narrowing of fundamental competitiveness—productivity, technology, product quality, and so forth.

As a result, I am still extremely concerned and I think there still is a problem of fundamental competitiveness in the United States which, if not addressed, will limit our long-term growth, and will make it difficult to bring the trade deficit down further without a reduction in living standards.

Anything we do in the economic policy arena has to take that issue into account.

Second, and highly related, is the budget deficit. I don't know where to begin on this subject because there is so much misinformation spreading, in my judgment, Mr. Chairman, about what has caused the budget deficit in the first place.

I keep hearing arguments that it is all on the spending side—Congress has not cut spending—which, in my view, is highly inaccurate. There have been large cuts in discretionary spending in the last several years.

But these have been offset by the increase in military spending, by continued growth in entitlements, and by the explosion of interest because we haven't addressed the deficit problem sooner.

In fact, if you look at the numbers, total discretionary spending has actually been very close to the Reagan budget submissions in the Reagan years. The mix between military spending and social spending has been different, but total controllable spending has not been far above what the administration requested.

In addition, on the tax side, the only thing that has kept tax revenues in line with the historical average, at least relative to GNP, has been increased Social Security taxes.

If you take Social Security taxes out, Federal Government tax revenues as a share of GNP are now close to the post-War II low; well below the post-War II average.

So I cannot accept the argument that the problem is all on the spending side. And we are not going to grow out of it. The deficit is starting to widen again and with any reasonable economic assumptions on interest rates and economic growth, at least in my judgment, absolute budget deficits will edge higher over the next several years.

And that does not take into account some needs that have developed in recent years that will have to be funded, such as the thrift crisis, the nuclear waste cleanup, AIDS research, drug control, or whatever.

When these are factored in, any reasonable conclusion is that we have made most of the progress we're going to make on the budget deficit using reasonable economic assumptions.

And the problem is worse than that because the true magnitude of the deficit is of course partly being camouflaged by the building Social Security trust fund surpluses.

If we don't do something more meaningful to reduce the Federal budget deficit, within 15 to 20 year, when the annual Social Security surpluses peak out and start to decline, I think we're going to see a unified budget deficit in the $400 billion a year range under reasonable economic assumptions. I believe this problem has to be addressed. In my view, it is going to have to be addressed, partly on the spending—and partly on the tax side.

I would like to see some spending cuts.

I've urged for years that we must slow the entitlements by considering means testing some of these programs and take stronger steps to slow the rate of increase in health costs.

But, even after that is done, I think there is no way to escape some tax increases during the next several years as a vehicle for bringing the budget deficit down on a gradual basis.

And I think we are running out of time. In my judgment, we are beginning to see some of the negative, long-term effects of budget deficits already in high-interest rates, and still relatively low investment, particularly for long-term projects, with most of current investment being channeled into short-term payback kinds of investments.

Deficits are increasing our dependence on foreign capital. They are worsening all of our competitive problems in world markets. And, in the long term, they are going to sap the vitality out of this economy if we don't do something about them.

In conclusion, Mr. Chairman, I think we have some serious underlying problems in this country despite the fact that we have had a long period of economic recovery. We have been kidding ourselves and, fundamentally, I think the two areas of focus for economic policy over the next several years are, first, to address the fundamental problem of productivity and competitiveness.

We need a national effort in this country to rebuild productivity growth after 15 years of marginal improvement. I think one focus of econmic policy should be:

What can we do to improve long-term growth in productivity?

And, second, cutting the budget deficit and doing so in a way that is consistent with improving our productivity and competitiveness in the long term. This would be a key step in that direction because it will increase national savings and if we can find the proper vehicle for translating those savings into productive investment, I think we will make a major contribution toward future economic growth.

Thank you, Mr. Chairman.

Representative **Hamilton**. Thank you.

All of your prepared statements, of course, will be entered into the record in full.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine, and I am the Chairman, Chief Executive Officer and Chief Economist of The WEFA Group. I am delighted to have this opportunity to testify before the Joint Economic Committee on the outlook for the U.S. economy for 1989 and 1990, and the key issues and policies that relate to both the short- and long-term outlook.

SUMMARY:

1. The recovery that began more than six years ago is still in tact. The expansion is now being led by a broad-based upturn in manufacturing and commodities industries, largely reflecting the turnaround in U.S. exports — the other major sectors of the economy, consumer spending, construction, and services, are growing more slowly than they did in the earlier years of this expansion. It should be noted that the length of this expansion period is partly the result of this shift among sectors of the economy, as well as the large debt buildup, in part to finance more spending, and the willingness of foreigners to fund much of this debt.

2. The economy is likely to continue to grow during 1989 and 1990, albeit at a much slower pace than during the previous two years. Furthermore, the sectoral mix which is now in place is likely to continue during these years. The expected slowdown in growth can be attributed to a number of factors, including slower growth in U.S. exports as the benefits from dollar declines already realized begin to diminish; continued sluggishness in construction; the inability of consumers to increase spending rapidly in view of weak real income growth, high debts and low savings; and the impact of more restrained fiscal and monetary policies. I expect GNP growth to average approximately 2% to 2.5% for these two years.

3. While the risks are high, an outright recession is likely to be avoided because of the favorable inventory situation which currently prevails; the fact that the rise in interest rates has been relatively mild and will only have a slight dampening effect upon the economy; the high order backlogs in most industries; and the likelihood that a major consumer retrenchment will be avoided in view of relatively favorable confidence and attitudes.

4. Any increase in the rate of inflation will be relatively modest in view of: (a) the likelihood that most of the drought impact on food prices has already been realized and that food price increases will be relatively moderate in the near future; (b) the impact of oil prices on the overall inflation rate is very small, especially in comparison with the 1970's; and (c) the typical wage-price spiral has been short-circuited by worldwide competitive pressures and by an increased emphasis on job security.

5. Large trade deficits will continue to be a major economic problem during the next several years — in fact, very little additional improvement from current levels is likely. This, coupled with the fact that inflation rates are higher in the United States than in many of our major trading partner countries, will likely cause the current dollar rally to be reversed and lead to modest declines in the U.S. dollar relative to most other currencies over the next several years. This, coupled with continued although modest economic growth and some increase in inflation, will likely keep both nominal and real interest rates high — in fact, I expect some increase in rates over the next several months, at least until an adequate budget deficit reduction package is put in place.

6. Despite the longevity of the recovery and the likelihood that a recession will be avoided during the next two years, the long-term outlook for the economy is far from favorable. In my view, economic growth over the next five-to-ten years will be hard pressed to average 2% to 2.5%, considerably below the long-term average. This reflects: (a) a major problem of fundamental competitiveness in the United States, in large part reflecting the weakness in productivity growth and other factors which have enabled many foreign producers to catch up or move ahead of the United States in technology and productivity; (b) the enormous buildup of private debt in recent years, which to some extent represents borrowing from the future; (c) the still enormous budget deficit, which in my view will restrain long-term economic growth by worsening our worldwide competitive problems, by holding down long-term investment, and by increasing our reliance on foreign capital; and (d) the inadequate level of savings in the United States, which magnifies all of the above. These factors are likely to lead to stagnation in real incomes and living standards, with most of the modest growth I now expect going to reduce our trade deficit and to service foreign debt.

7. I believe very strongly that now is the time for a national effort to restore our productivity and competitiveness, with the objective of realizing major improvements by the end of this decade. In my view, such an objective will have to be led by actions here in Washington, through more favorable economic policies, and by setting goals for the private sector. This will require cutting the budget deficit in order to increase national savings; changing our priorities within the budget to spend more on building for the future rather than on current consumption; taking steps to promote a longer term focus in the private sector; and, dramatically improving the quality of education in this country. One of the major steps that the Federal Government can take in this process is to implement a credible program which will reduce the federal deficit (excluding social security surpluses) on a gradual but certain basis during the next several years — this will require a combination of some modest revenue increases as well as scaling back the growth in entitlement programs on the spending side.

THE EXPANSION THUS FAR

As has frequently been pointed out, the recovery which began in late 1982 is now in its 75th month, making it one of the longest expansions on record. However, in my view, while the economy's performance in most respects is now far better than it was in the late 1970's and early 1980's, the health of the economy has generally been overstated in recent years, for the following reasons:

1. The back-to-back recessions in the early 1980's produced such pervasive weakness in the economy that the base from which this expansion began was extremely low — unemployment, the amount of excess capacity, and most other measures of economic performance were at, or close to, their postwar lows when this recovery/expansion began. Thus, a longer than normal expansion was necessary in order to return the economy to a relatively healthy and prosperous condition. This is especially true since the rate of economic growth over the last six years has not been higher than in previous recoveries (and, in fact, has been lower than in several others).

2. When the 1981-82 recession is taken into account, economic growth during the 1980's, even with the long expansion, has still lagged behind that of other postwar decades.

3. The large number of new jobs created over the last six years partly reflects a catch-up from the unemployment that developed during the two recessions of the early 1980's. Furthermore, the rate of job growth during this decade has actually lagged behind that experienced during the Carter Administration, and, to some extent, has occurred at the expense of productivity growth.

4. The personal saving rate during the last seven years has been significantly below previous years, even after adjusting for demographic changes and other factors, and despite sharp cuts in marginal tax rates, the enactment of various savings incentives, and extremely high real interest rates. Furthermore, net investment as a share of GNP has been considerably lower in the 1980's than during previous decades.

5. The expansion has been accompanied by one of the biggest increases in both public and private debt since the 1920's, by widening strains in the financial system, and by a rapidly building reliance on foreign capital.

Other aspects of the long expansion are also interesting, including the sectoral pattern. The first four years of this period were characterized by very rapid growth in consumer spending, in construction of almost all types (excepting new plant construction), by sharp increases in defense spending, and by a boom in financial and other services. At the same time, most manufacturing industries and most commodity producers lagged considerably behind, and in some cases, did not participate in the overall recovery at all. This reflects the very sharp increase in the trade deficit, caused by weak exports and rising import penetration, which held down those industries that were most directly affected. In the last two years, the pattern has essentially been reversed — it has been the improvement in manufacturing and commodities which has allowed the overall expansion to continue while consumer spending, construction, etc. have experienced either slower growth or weakness. In my view, upward of 70% of the rebound in manufacturing and commodities over the last 24 months reflects the direct and indirect effects of the increase in exports and the resulting decline in the trade deficit (especially in real terms) during this period.

It should be noted that the slowdown in other sectors is not pure coincidence. In fact, in my view, most of the limited turnaround in the trade deficit that has been experienced has been the result of cost-cutting (especially wage restraint) and of the sharp decline in the dollar since mid-1985. However, while these adjustments have helped individual companies compete more effectively (leading to the upturn in exports), they have led to higher inflation, a squeeze on real wages, and contributed to relatively high real interest rates, all of which have held down domestic demand and caused a slowdown in those sectors mentioned above. Thus, the improvement in the trade deficit has not come without substantial costs for the rest of the economy.

Before looking ahead, it is important to note the causes of this economic expansion. In my view this expansion was not produced by a supply-side revolution, but rather by a large number of factors. First, the enormous fiscal stimulus injected into the economy by the massive net tax reductions enacted in 1981 and by the large military buildup have clearly been a factor in the recovery process. Second, the dramatic easing of monetary policy that was initiated in the summer of 1982 (as indicated by both declining interest rates and rapid growth in the money supply), and the relatively easy monetary posture since then, have also been major contributors. Third, to some extent the recovery was purely cyclical, reflecting the large amount of pent-up demands and excess capacity that were created during the back-to-back recessions of the early 1980's. Fourth, the favorable effects of the sharp decline in oil prices during the 1980's enhanced household purchasing power. Fifth, the longevity of the recovery is also in part the result of the change in sectoral mix discussed previously, so that different pockets of strength emerged at different times to continue the expansion process. Finally, and most importantly, the length of the recovery period also in part reflects the incredible willingness of the economy to incur more debt and the willingness of foreigners to lend us that money at reasonable interest rates. Without this, the recovery would have been more sluggish and/or shorter.

My concern is that most of the factors contributing to the recovery are not permanent -- at some point fiscal stimulus will have to be tapered back; the ability to service more and more debt and/or the willingness of foreigners to provide it, is not open-ended; most of the cyclical rebound is already past; and oil prices have probably bottomed out during this cycle.

THE SHORT-TERM OUTLOOK

A year ago the prospects for the United States looked uncertain at best. The financial market convulsions that led to the stock market crash brought all the bears out of their closets and forecasts of a recession abounded. The WEFA Group's real GNP forecast of about 2.5% growth for 1988 was considered overly optimistic. The reality, of course, was that even our forecast underestimated the strength of the U.S. economy last year.

Why was 1988 so much stronger than most forecasters expected? There are several reasons. First, the United States and the world economy were growing at very rapid rates prior to the crash. This, combined with the almost negligible wealth effect, meant that growth did not slow significantly. Second, the Fed and other central backs acted swiftly and in concert to offset the potential impacts of the crash on the real economy. Third, monetary stimulus abroad meant that Japan, Europe, and the rest of the world grew at a 4% rate, setting the stage for strong export growth in the United States. Fourth, despite the strong growth in the United States and abroad, there was enough slack on a worldwide basis that inflation rose very little.

While the economy did do relatively well in 1988, and better than expected, it is important to note that economic growth decelerated as the year progressed, a pattern I expect to continue during the next two years, reflecting:

1. Export growth has slowed dramatically during the last six months following the near 30% annual rate of growth during the prior 18 months. This has caused the trade deficit to essentially flatten at an annual rate of approximately $135 billion, following substantial improvement in 1987 and early 1988. The trade deficit is likely to stay at current levels in the near future because: (a) The high level of capacity utilization in many trade-related industries is slowing the growth of U.S. exports and is keeping imports for some commodities and products higher than they would otherwise be because of inadequate capacity to supply domestic needs. (b) The share of imports coming from lower-wage countries which have been relatively

unaffected by exchange rate changes is increasing. (c) Oil imports are trending upward. (d) Previous levels of agricultural exports will not be reached because of increasing agricultural productivity outside of the United States. (e) There is some slowing of economic activity now underway both in Europe and Japan, and still weak conditions in Latin America and Africa.

2. Construction spending on an overall basis is no longer contributing to economic growth. Construction of new offices, apartments and condominiums have been trending downward for the last several years and will continue to do so — some weakness in commercial construction has also set in. Furthermore, the pickup in new plant construction has been relatively mild.

3. Military spending in real terms has flattened after rising sharply for several years.

4. Interest rates have risen during the course of 1988, and at the margin are slowing consumer spending and construction somewhat.

5. Most of the slack in the economy that previously existed has already been used up.

The economy is thus likely to continue to grow during 1989 and 1990, albeit at a much slower pace than during the previous two years. Furthermore, the sectoral mix which is now in place is likely to continue during these years. The expected slowdown in growth can be attributed to a number of factors, including continued slower growth in U.S. exports as the benefits from dollar declines already realized begin to diminish (as discussed below); continued sluggishness in construction; the inability of consumers to increase spending rapidly in view of weak real income growth, high debts and low savings; and the impact of more restrained fiscal and monetary policies. I expect GNP growth to average approximately 2% to 2.5% for these two years.

While the risks are high, an outright recession is likely to be avoided because of the favorable inventory situation which currently prevails; the fact that the rise in interest rates has been relatively mild and will only have a slight dampening effect upon the economy; the high order backlogs in most industries; and the likelihood that a major consumer retrenchment will be avoided in view of relatively favorable confidence and attitudes.

This forecast for 1989 and 1990 is based on the following assumptions:

1. **The Drought:** The Commerce Department estimates that the drought reduced real farm production by $12.8 billion in 1988. The estimated negative impact on fourth-quarter real GNP

growth was about 1.1 percentage points. Real growth was depressed 0.9 and 0.5 percentage points in the second and third quarters, respectively, as a result of the drought. The expected recovery of farm production in 1989 should temporarily boost overall real growth by about 2.5 percentage points in the first quarter of 1989.

2. **Oil Prices:** The production agreement reached by OPEC in late November has pushed oil prices up thus far this year, but high inventories, anticipated cheating on the production quotas, and weak world demand will again push oil prices downward in the second half of 1989 and into 1990. The refiners' acquisition cost (RAC) should average about $14.94 and $14.56 in 1989 and 1990, respectively.

3. **Taxes:** I assume that $40 billion of tax increases will be phased in starting in late 1989. I have assumed that a $10 billion increase in excise taxes will occur in 1989.4 and a $10 billion increase in income taxes (half personal and half corporate) will be put through for 1990.1. A second $20 billion package is assumed to be implemented in 1990.4 ($5 billion excise taxes and $5 billion corporate taxes) and in 1991.1 ($10 billion personal taxes). I will discuss the need for tax increases in more detail below.

4. **Government Spending:** As measured on a NIPA basis, outlays are now estimated to average $1171 billion in FY 1989, $1242 billion in FY 1990, and $1314 billion in FY 1991.

5. **Minimum Wage:** I assume that the minimum wage will be increased by $0.40 in the third quarters of 1989, 1990 and 1991.

6. **Foreign Output and Inflation:** My estimates for real growth of foreign output for 1988 through 1991 are 3.7%, 3.6%, 2.5% and 2.9%.

More Monetary Tightening is Likely

Despite the tightening of monetary policy that was initiated last March — the federal funds rate has risen almost 200 basis points over the last nine months — final private domestic demand (FPDD), the sum of consumption, fixed investment and state and local government purchases, continues to expand at a clip exceeding 3%. Until there is clear evidence of a slowdown in the growth of FPDD to about 2%, it is likely that the Fed will continue to push up interest rates. My current baseline forecast calls for the growth of FPDD to drop to 2% in the first half of 1989. Hence, I assume that the fed funds rate will continue on its upward course until spring. Short-term interest rates are likely to come down very slowly later in the year, however.

Continuing rises in interest rates should push down the interest-sensitive sectors of the economy in 1989 and 1990. First, new car sales should drop from 10.6 million units in 1988 to only 10.1 million units this year. Second, housing starts will decline further in 1989. The effective mortgage rate is projected to average about 9.8% in 1989, compared to 9.2% last year. Each 0.1 percentage point rise in effective rates reduces starts by about 10,000 units. Hence, I expect starts to average 1.41 million units in 1989, down 60,000 units from 1988. Third, business fixed investment will likely expand at a less robust rate in 1989. The 1988 boom in purchases of producers' durable equipment will become more subdued with higher interest rates, slower output growth, high (but not rising) capacity utilization, and smaller increases in after-tax profits. A large part of the 6.8% increase in PDE spending will likely be in the office and computer category.

The Treasury yield curve flattened once again in November and in December as the release of various economic indicators caused short rates to rise more than long rates. The spread between the yield on the 30-year Treasury and the (bond-equivalent) yield on 91-day T-bills averaged 98 basis points in November, down sharply from October's 130 basis points. The curve has not been flatter since June of 1982. Yield spreads are especially flat between the intermediate and long ends of the curve: only 9 basis points separated the yields on two-year notes and the 30-year bond in early December.

Why is the Treasury yield curve so flat? A flat yield curve normally presages weak economic growth. This is so because under the expectations theory of the yield curve, the expected one period rate of return on investments is the same, regardless of the security's maturity. Under this theory, an investor with an investment horizon of one year could purchase a 1-year Treasury note, a 2-year Treasury note which he sells after one year, or a 5-year Treasury note also sold at the end of one year, and expect to receive the same return on each investment. A 30-year Treasury bond, for example, could be thought of as simply a discrete series of maturing 3-month Treasury bills. Thus, forward rates of interest embodied in the term structure are considered unbiased estimates of expected future spot rates of interest. When the term structure if flat, long-term investors are expecting short-term rates to fall in the future.

The current flatness implies that rates are unlikely to rise in the near future. However, the market's expectation of lower interest rates in the near term will not materialize in my view. I believe that the current yield curve is too flat and will steepen in early 1989. Long rates will rise at least 50 to 100 basis points above current levels.

One factor behind the curve's flatness has been the relative supply of bonds versus bills. The Treasury was unable to sell new 30-year bonds at its August refunding (it was able to sell them at its November refunding), producing a shortage of long bonds and thus depressing their yields vis-a-vis those of other Treasury bonds. Issuance of Treasury bills, however, was up 8% to 9% in October and November from year ago levels. In addition, the dollar's behavior has played a major role in the yield curve's shape. In 1987 the yield curve was relatively steep because the falling dollar made purchases of long Treasury bonds by private foreign interest unattractive; foreign central banks intervened by purchasing bills. In 1988 private foreign purchasers bought Treasury bonds once again while foreign central bank intervention was down sharply from 1987.

The Boost to Growth from Improving Trade Will Diminish

Export growth rates averaged 20% for all of 1987 and the early part of last year. But the dollar has depreciated much less rapidly over the last twelve months. Combined with tight capacity pressures in many export and export-supplying industries, which will put additional upward pressure on our export prices thus making them less attractive, I expect that export growth will drop to less than 7% in 1989. Growth is likely to slow in all major export categories.

Weakening domestic demand in 1989 as well as higher imported price inflation will pull down the rate of increase of imports. But the expected 50% reduction in import growth from 8% in 1988 to 4% in 1989 does not match the nearly two-thirds drop in export growth. Hence, net exports will contribute only about 0.3 percentage points to overall growth in 1989 compared to an expected 0.8 percentage point contribution in 1988.

THE OUTLOOK FOR INFLATION

Fears that the economy is growing too fast and that inflation is going to accelerate have spread during much of 1988. However, while I expect some acceleration, fears of a rapid buildup of inflation are exaggerated. The upward pressures on inflation include: (a) capacity constraints in many industries, especially export-oriented commodity industries; (b) tight labor markets in many geographic areas; (c) increases in the prices of many imported goods, largely reflecting the long period of dollar depreciation; and (d) increases in the prices of many domestically produced goods which compete with imports. However, it is important to emphasize that these forces are producing and will continue to produce only a very gradual upward trend in inflation. The risk of inflation moving above substantially above 5% is small, reflecting the following:

1. Economic growth has already begun to slow — and, while industrial production will likely continue to outpace overall GNP growth, it is also slowing considerably from the near 8% rate of increase during 1987. This is already beginning to slow the upward movement in the prices of many materials, preventing capacity bottlenecks from worsening. Some ##?fo this slowing is a direct response to higher interest rates — the increased speed with which the bond market reflected higher inflation in early 1988 became an automatic restraining factor on inflation, unlike the past when long-term rates would rarely move up unless the Federal Reserve tightened first.

2. The sharp increase in wages for entry level jobs in some areas, reflecting labor shortages, has not spread to other workers — average wages thus continue to be relatively restrained and are lagging behind the rise in the CPI. In my judgment, this reflects a number of factors which have changed the wage setting process, so that average wages now rise less than they have historically for any given level of unemployment and CPI increase. These factors include the highly global competitive environment, which has put more pressure on U.S. corporations to hold costs down; the declining significance of relatively high-paying manufacturing industries in the overall economy; the elimination or scaling back of automatic cost-of-living adjustments in a large number of union contracts (many nonunion corporations also now give less weight to the CPI in their salary-setting process); and perhaps most importantly, the increased concerns for job security that have been caused by widespread layoffs, mergers and acquisitions, and general corporate restructuring in recent years.

3. Despite the drought, food price increases should be relatively modest during 1989. As soon as it became apparent that the country's crops were being adversely affected by the drought, farm level prices for those commodities increased sharply — these have worked their way through the marketing channels and have already contributed to substantial gains in the consumer price index for food. The uncertainty about crop production has dissipated and commodity prices have lost their volatility. The dramatic increases in food price inflation caused directly by crop price increases are thus largely behind us.

4. Crude oil prices were weak for most of 1988 — while prices are now trending up, oil will not be a significant inflationary force, unlike the 1970's.

In sum, inflation during the next 18 months will be somewhat higher than it is currently, but a substantial and sharp acceleration is not likely.

OUTLOOK FOR THE BUDGET DEFICIT

My estimate of budget deficits, assuming no new policy changes, are much larger than the recent projections of the outgoing administration. I expect a deficit of approximately $160 to $165 billion in the current fiscal year, and at least $150 billion in FY 1990, without major deficit-cutting actions. This reflects a number of factors, but primarily my view that the economic assumptions embodied in the last administration budget were extremely optimistic (especially the combination of rapid economic growth and a sharp decline in interest rates), plus the unlikelihood that the Congress will implement many of the spending cuts included in that budget.

The rigid position taken by President Bush on taxes during his campaign and the widening split within the National Economic Commission will complicate the task of deficit reduction. In my view, revenue increases will have to be part of any credible package to reduce the budget deficit. This conclusion is based upon the following:

1. **The United States will not grow out of the deficit.** While many point to the declining deficit of recent years, especially as a percent of GNP, it is important to note that the deficit/GNP ratio (now slightly more than 3%), is still extremely high for this stage of an economic expansion. In fact, in the latter years of previous recovery periods, the budget deficit has almost always been less than 1% of GNP, and in several cases small surpluses occurred. Furthermore, the evidence strongly suggests that economic growth will moderate during the next several years. The modest growth profile projected for the medium term would lead to a decline in the deficit/GNP ratio to no better than 2% to 2.5% at best over the next five years in the absence of any new deficit reduction measures.

2. **Net spending cuts are likely to be relatively small.** Both the budget arithmetic and the politics suggest that spending cuts will make only a limited contribution toward deficit reduction during the next five years. Significant reductions in military spending are unlikely since the Pentagon will need to implement a major scaling back of some existing programs just to stay within current projected spending levels. The primary problem is that the cost of maintaining the increased base of weapons systems that have been delivered in recent years is up sharply, and more weapons are scheduled for production and delivery during the next several years. Thus, while major increases in military spending from current levels will not take place, sizable cuts from current budget levels will be difficult to achieve. Furthermore, any cuts in spending on health, pension or other entitlement programs that may be implemented during the next several years are likely to be structured in such a way that they will not affect spending levels significantly until many years into the future. Thus, entitlement costs will rise in the

foreseeable future. Finally, the President's flexible freeze would require massive cuts in the nondefense portions of the budget. Such cuts are highly unlikely because these programs have already been cut sharply — neither Congress nor public support appears to exist for additional large cuts. Spending for some programs is actually likely to rise significantly during the next several years, including drug abuse control, environmental programs, and education.

3. Some factors will push the deficit higher. In addition to the slim probability of rapid economic growth and/or a major reduction in total spending to dramatically reduce the deficit, there are other factors that are working in the opposite direction, including: (a) The gradual acceleration in inflation now underway is actually a small minus for the deficit because a significant part of the inflation is (and will come) from higher import prices, which push up the cost of the indexed programs. Because these price increases are not filtering into wage increases in a major way, and because of the indexing of personal tax rates, the impact on tax receipts is smaller. (b) The rapidly rising federal debt, coupled with rising nominal interest rates, is causing continued rapid increases in interest expenses at a time when interest payments are already a large part of total expenditures. (c) Over the next five years, there is likely to be as much as $500 billion spent on as yet unfunded programs such as the bail out of the ailing savings and loan industry, the upgrading of the government's nuclear weapons manufacturing facilities, and the cleanup of the government's toxic waste dumps.

MAJOR LONG-TERM ISSUES

In my view, the long-term outlook for the economy is far from rosy — the slowdown in growth that is now beginning will likely continue for many years, for the following reasons:

1. U.S. Competitiveness: I believe the major factor affecting the U.S. economy today is the change in U.S. competitiveness in the last ten or fifteen years. U.S. productivity and technology advantages were so large during the early postwar years that the United States was able to maintain dominance in world markets, and generate large ongoing trade surpluses, despite funding much of the free-world's defense, despite having very open markets, and despite cultural and trade barriers which limited access to some other markets. However, even though U.S. manufacturing has remained relatively stable as a share of GNP, these basic advantages have been narrowed dramatically, primarily by rapid productivity growth among traditional foreign competitors, and by the emergence of many highly productive new competitors in the last 15 years, reflecting : (a) the speedier transfer of U.S. developed technology to the rest of the world, (b) a more rapid rate of new innovation in many other countries than in earlier years, (c) a strong emphasis on product quality and design, (c) high saving and investment rates, (e) the

rebuilding of World War II ravaged infrastructures with the most modern equipment (and the use of such equipment in the NIC's), (f) the increased mechanization of agriculture, (g) the lower base from which many foreign countries started, and (h) an emphasis on rapid growth, both domestically and in exports, in order to generate the higher profits necessary to fund additional investment, and research and development. During the same time, productivity growth in the United States was slowing dramatically relative to the earlier postwar years, making it much easier for the rest of the world to catch up.

The net effect of these factors has been to sharply narrow the differences in productivity and product quality which existed previously between the United States and older competitors, at the same time that a large number of new, highly efficient competitors emerged — in fact, average productivity levels in many tradable goods industries are actually now higher in Japan and some other countries than they are in the United States (although not on an overall economy basis, because U.S. productivity levels remain higher in various other industries). As a result, relatively high wage and capital costs in the United States can no longer be justified by productivity differences, and represent an enormous competitive disadvantage — the combination of these developments has caused a rapid shift away from U.S. dominance in world markets, with sharp declines in the U.S. world-market share for most manufactured and agricultural goods, massive trade deficits, and rapidly growing foreign debt. These trends have been aggravated by the enormous U.S. budget deficits and the overvalued dollar of recent years, by slow growth overseas, and by the LDC debt crisis.

The decline in fundamental competitiveness (i.e., in relative productivity), and its likely affect on future economic growth (to be discussed below), has often been unrecognized because of the following:

A) **The manufacturing/GNP ratio (in real terms) has remained relatively stable, suggesting that the United States is not de-industrializing.** It now appears that revised data will show that manufacturing output has fallen as a share of GNP during the last 10 to 15 years. Furthermore, even stability in manufacturing output as a share of real GNP in recent years would actually demonstrate the erosion of U.S. competitiveness when it is viewed in the context of the rapid rebound in the demand of manufactured goods (relative to total demand) in the United States, reflecting the large turnaround in consumer durables, the procurement-dominated military buildup, and the tax-incentive-led pickup in investment in the early 1980's. The surge in demand for goods has been so strong that it may have prevented the manufacturing/GNP ratio from declining sharply despite the loss of U.S. market shares (and the related influx of imports and slowdown in exports) —without the change in relative competitiveness, the manufacturing output/GNP ratio would have risen sharply during the 1980's. This also explains why U.S.

manufacturing output grew more rapidly than in the rest of the world during the initial stages of the recovery — the U.S. market, in which the U.S. has a relatively large (but declining) share, has grown much more rapidly than markets overseas. Finally, maintaining a near-stable manufacturing/GNP ratio over the last 15 years has been possible only in part by a steadily declining dollar relative to most currencies during the 1970s, which offset some of the widening unit labor cost differentials at that time.

B) The U.S. economy has grown more rapidly than most other industrialized countries during recent years — this is often cited as the primary cause of large U.S. trade deficits. However, while faster economic growth in the United States has obviously increased the trade imbalance in recent years, it does not account for the sharp rise in import penetration rates (rather than just import levels), and the decline in U.S. exports in real terms in the early 1980's (even though economic growth outside of the United States was positive, although modest). These have combined to cause the sharp decline in the U.S. share of worldwide production in most industries referred to earlier, and in overall world trade, during the 1980's.

C) The onset of massive trade deficits has coincided with large budget deficits, leading many to conclude that the budget imbalance, by pushing up interest rates and the U.S. dollar exchange rate, is the dominant cause of our trade problems. However, as best evidenced by the rapid rate of increase in the U.S. trade deficit with Japan, and the steady decline in the U.S. dollar relative to the yen and other industrialized currencies in the 1970's, our trade problems were developing well before the 1980s. The full extent of underlying deteriorating competitiveness at that time was temporarily masked by the surge in exports to Latin America (financed by unsustainable U.S. bank lending, much of it directly tied to exports), by rising exports to OPEC countries (in response to oil-revenue-financed development and construction programs), and by the relatively weak dollar. Large U.S. budget deficits have clearly made the trade deficits worse, both by pushing up the U.S. dollar in the early 1980's, and by directly stimulating demand; however, increasing foreign competitive pressures would have occurred even in the absence of unbalanced U.S. fiscal policies.

D) Some claim that our competitive problems have been dramatically reduced in recent years as evidenced by a large rebound in manufacturing productivity and by a turnaround in the trade deficit. In my view, the patterns during the last several years do not indicate any major change in U.S. fundamental competitiveness. First, while manufacturing productivity has accelerated somewhat, much of the improvement reflects one-time actions such as plant closings, corporate staff reductions and job outsourcing. Not only will these not lead to continuing gains in productivity, but even with these factors, productivity in U.S. manufacturing has not grown more rapidly than in most of our foreign competitor countries. Furthermore, the impact of some of these actions has simply been to shift the productivity problem elsewhere in the economy — thus, overall productivity growth has decelerated to the 1% trend rate which has prevailed since 1973. Second, the key factors which will determine productivity in the long term, such as the quantity and quality of education, spending for research and development, net investment, etc. have not shown any significant improvement. Third, while the trade deficit has clearly improved, especially in real terms, it is still exceptionally large by any standard. Furthermore, as discussed earlier, the improvement has stalled at a high level over the last six months. Finally, I estimate that upward of 90% of the improvement in U.S. competitiveness during the last two years reflects the impact of the weaker dollar and of cost cutting, rather than (as implied above) any major change in fundamental competitiveness — while these adjustments have helped individual companies increase their exports, they have negative side effects on the economy by adversely affecting inflation, purchasing power, and interest rates, and thus do not represent an ideal solution to our competitive problems.

In my view, a significant additional narrowing of the gap in real wages between the United States and many other countries will be necessary to bring them in line with productivity differentials — this will further reduce the U.S. trade imbalance over time. In view of the still slow rate of increase in wages and strong productivity growth in many other countries, much of this will have to be accomplished by the following: (a) Additional sizable declines in the U.S. dollar, which I expect on a gradual basis during the years ahead. (b) Continued wage restraint in the United States, especially as low-wage countries increasingly become the major competitors in more and more industries. (c) Continued efforts to improve productivity will be made; however, as in recent years, it is likely that some of these improvements will occur as a result of employment reductions (especially of high-wage jobs) unrelated to improvements in manufacturing efficiency. These adjustments will take place because rapidly growing U.S. foreign debt cannot continue indefinitely — at some point, the rest of the world will reach the limit of dollar absorption, so that U.S. trade deficits will have to be dramatically reduced. In fact, the United States will likely have to run trade surpluses at some point in order to generate the foreign exchange to service the large foreign debt that will exist.

These likely adjustments to deteriorating relative U.S. competitiveness will all hold down domestic demand and living standards in the future — in fact, purchasing power is already beginning to stagnate. This, coupled with low savings rates, already high debt burdens, eroding confidence, and other factors, will limit the growth in consumer spending on a secular basis.

2. **Federal Budget Deficits:** In my judgment, and despite those who now claim that the deficit is disappearing on its own, or that they really don't matter, the extremely large budget deficits of recent years, and those expected in the future, will have negative consequences for

the U.S. economy for many years into the future. To address this, I think it is first necessary to focus on some of the myths that have spread regarding the importance of budget deficits.

Myth #1: Large budget deficits were caused by the sudden and unanticipated 1981-82 recession. While it is true that the 1981-82 recession increased deficits (in that and succeeding years) over and above what they would have been, the recession explains only a small portion of these deficits. In particular, the Administration's economic program put in place large full-employment deficits for the years ahead — the effect of the recession only added to those to produce even higher actual deficits, but they would have been large in any case.

Myth #2: The large deficits are the result of the disinflation which has reduced growth in the nominal income base. Based on my calculations, this has been a relatively small factor in recent budget deficits because inflation has also slowed the growth in federal expenditures, especially for indexed programs.

Myth #3: Massive budget deficits have been caused by the failure of the Congress to implement the spending cuts that President Reagan proposed. In my judgment, this too is a highly inaccurate and misleading explanation of recent deficits, because: (a) While the Congress has not implemented all of the Administration's recommendations for cuts in social programs, it has nonetheless made sizable cuts (as a percent of GNP, discretionary nondefense expenditures have declined by two percentage points in recent years). The Congress has also authorized less growth in military spending than the Administration has requested. Thus, total federal expenditures (excluding interest) have risen at a rate very close to President Reagan's recommendations in recent years — the major difference has been in the mix between defense and nondefense programs. Furthermore, interest expense has consistently outpaced Administration and Congressional projections because the continuous use of unrealistic economic assumptions has caused actual budget deficits to far exceed official projections, causing the national debt to grow more rapidly than forecast. In effect, the Congress has struggled each year to make very difficult budget cuts, only to find that the effect on the deficit has been swamped by slower-than-forecast economic growth and by the surge in interest payments. Additionally, the modest tax increases that were passed by the Congress in 1982 and 1984, despite the Administration's initial objections to those tax increases, actually prevented what would have been even larger budget deficits.

Myth #4: The budget deficit has been caused by the budget process. In my view, there is absolutely no validity to this assertion whatsoever — there is no budget process that could have prevented the large budget deficits in recent years. In particular, no other budget process would likely have: (a) prevented the Administration from using such optimistic assumptions, (b) prevented the enactment of the 1981 tax cut, (c) made the Administration willing to raise taxes in recent years, or (d) produced much more sizable cutbacks in federal expenditures.

Several other arguments are often made to downplay the significance of budget deficits. These include the following:

1. After adjusting for inflation and other factors, current deficits are really much smaller than the numbers indicate. While this may be technically correct, it overlooks the most significant aspect of budget deficits in recent years, namely that they are absorbing a much larger fraction of our national savings than has ever been the case in our history, no matter how you define and measure these deficits. Furthermore, and perhaps even more importantly, annual federal interest payments now make up a much greater share of both federal spending and GNP than at anytime in our history, even during the immediate post WWII period. Thus, the burden of financing federal deficits is now much higher. In addition, any shock which raises interest rates would have a much bigger effect on federal spending and on capital markets now than was the case historically when federal interest was a smaller portion of the economy.

2. The Federal Debt/GNP Ratio is far below where it was at the end of World War II. It is true that the ratio declined sharply until the mid-1970's, but the essential point is that it was offset by rising debt burdens elsewhere in the economy, so that overall indebtedness was essentially stable. Recently, however, the rising trend in the Federal Debt/GNP has come on top of increases in other parts of the economy. Furthermore, most of the national debt prior to the 1950's was accumulated during WWII, an emergency situation. Finally, extremely favorable conditions which enabled the U.S. economy to experience rapid growth on an ongoing basis after WWII, such as the enormous pent-up demands which existed, and the fact that our economy suffered less war damage than other countries, enabled us in a sense to pay-down that debt (reducing the ratio) fairly dramatically. What is most disturbing about the current situation is that the Federal Debt/GNP ratio has risen during a period of relatively strong economic growth which is unlikely to continue in the future.

And, as discussed earlier, we are not likely to grow out of these deficits — the budget deficit outlook is still very poor. In fact, the current unified deficit really understates the magnitude of the problem because it is being increasingly camouflaged by rising social security surpluses — the operating budget deficit is still over $200 billion and is likely to rise further during the next several years. What is of most concern is that if nothing is done to reduce these operating deficits, the unified budget deficit will begin to rise sharply as we move into the next century, as the annual social security surpluses reach their peak, begin to decline and ultimately become negative as the reserves now being accumulated are paid out to the baby-boomers as they retire. Thus, on a long-term basis, the budget outlook is horrendous.

There are many reasons to be concerned about this budget deficit outlook. First, real interest rates remain extremely high — in my view, this in part reflects the direct effect of massive federal borrowing in the United States, and also the indirect effects as large deficits have reinforced the inflationary expectations that developed during the 1970's. These high real rates are restricting investment in new capacity and other investment projects which have a relatively long payback. Second, the U.S. economy is much closer to full employment than at any time in recent years, and thus some reduction in demand through deficit reduction is necessary to free up more resources for exports and other private sector needs. Third, the United States has become enormously dependent on foreign capital in recent years, much of which is being used to finance budget deficits. This has rendered us extremely vulnerable to changing exchange rates, changing attitudes of foreign investors, etc. We continue to risk a financial crisis being brought about by a significant reduction in foreign investment — the absence of credible actions to reduce U.S. budget deficits could potentially trigger such a crisis. Furthermore, increased foreign investment in the United States comes with a high cost — it will need to be serviced in the years ahead, which will drain increasing amounts of income from the system.

Some argue that despite the poor deficit outlook, taxes should not be raised because the problem is "too much spending, not insufficient revenues" and/or borrowing to finance deficits is no different than raising taxes. Those who advocate only spending cuts as a solution point out that federal taxes as a share of GNP are roughly in line with the historical average, supposedly demonstrating that the problem is really on the spending side. However, this is misleading at best, because total tax receipts now include the impact of the large social security tax increases that were enacted in 1983 to build up the trust fund. Excluding social security taxes, federal revenues as a share of GNP are now well below the historical average and, in fact, are near the low point of the entire postwar period. This of course reflects the large net tax reductions enacted beginning in 1981 (only partly offset by some tax increases thereafter). Furthermore, despite the claim made by many supply-siders about how rapidly tax revenues have grown in recent years, tax revenues other than Social Security taxes have lagged behind the growth of GNP since 1981. Further, as I pointed out earlier, there have been substantial cuts in spending in recent years — however, they have been offset by increases in military spending, entitlements, and interest. And, I believe there is a large difference between borrowing or raising taxes to finance spending — borrowing produces much higher interest rates, increases our dependence on foreign capital, squeezes out long-term productive investment, keeps inflationary expectations, and thus real interest rates much too high, and worsens our long-term competitive problems. Furthermore, modest tax increases will not kill the economy in the short term — if they are phased in slowly, the impact will be small and gradual, and in fact will be partly offset by lower interest rates. And there is little evidence to suggest that modest tax increases will have a more negative effect on the economy in the short term than additional budget cuts — in fact, the tax increase route may be better for long-term economic growth than cutting some spending programs that will affect productivity and competitiveness.

In sum, there is still a large budget deficit problem in the United States — we are not likely to grow out of it. On a long-term basis, the problem will become worse. Furthermore, it has been caused primarily by the combination of the large military buildup and large tax cuts enacted in the previous eight years. In my view, these budget deficits are already beginning to have negative effects on productivity, competitiveness, and economic growth and if the problem is not addressed in a satisfactory fashion soon, the impacts are likely to worsen. Finally, the problem is not simply the size of the deficit, but the priorities embodied in it. In my view, far too much of current spending is being used to finance military expenditures, entitlements, and other types of current consumption, and almost none is being used to build for the future. Thus, it is essential that we reduce the budget deficit at the same time these priorities are changed.

3. **Buildup in Private Debt:** The sharp increase in private indebtedness in recent years will also limit economic growth by holding down the growth in consumer spending and business investment. Future spending growth will be affected because the leeway for many businesses and individuals to go deeper into debt in order to fund new spending has diminished — in addition, it has made the economy far more risky, as either a sharp increase in interest rates and/or an economic downturn could cause far more serious dislocations than have been experienced in the past. The debt burden is particularly troublesome because most of the debt has been used to fund financial transactions and current consumption, rather than new investment, and since much of it has been financed by increased leverage, and by borrowing from overseas (which will draw income out of the U.S. economy in the years ahead). This large buildup in private debt has been accompanied by a sharp decline in private savings.

As a result of these factors, I believe that economic growth during the next 5 to 10 years will be considerably less than in recent years, and far below the postwar average. Several warning signs about slower growth in the future have already emerged. These include the following: (a) There is still a weak underlying trend in productivity. (b) Capacity constraints discussed earlier in many industries will limit potential growth. (c) The labor force is growing more slowly, and now that the economy is closer to full employment, there will be less of an increase in new employment to produce economic growth. (d) Stagnation in real wages has already developed. (e) There is widening income inequality. (f) Housing, education and health care are less affordable for many families. (g) Financial strains are increasing. These changes have also made the economy much more risky and much more vulnerable to shock than at any other time in postwar history.

POLICY RECOMMENDATIONS

The top economic priority for the rest of this century must be to accelerate the underlying trend in productivity growth from the dismal performance of the last 15 years. Productivity grew by an average of nearly 3% per year in the 1950s, 1960s and early 1970s; since 1973, it has decelerated to an annual average of less than 1%. As a result, average productivity is now over 20% less than it would have been had the previous trend continued. Many explanations have been offered for this near-stagnation in economic efficiency, but the obvious conclusion from the research that I and many others have done in recent years is that no one single factor, such as shifting demographics or any other relatively uncontrollable factor, is responsible. Rather, the evidence suggests that a multitude of factors, each making a relatively small contribution, are at fault. These factors include the need to absorb large numbers relatively inexperienced new entrants into the labor force; an increasing share of business investment going toward energy conservation, environmental needs, and other relatively unproductive (although perhaps necessary) activities and needs; declining research and development; a substantial reduction in invested capital per worker; a shifting mix away from relatively high productivity sectors toward those with lower averege productivity; a reduced focus on the importance of manufacturing; etc. Most disturbing is that overall productivity growth has remained sluggish in recent years despite many favorable factors, such as declining oil prices, the relatively long period of economic expansion, and the large amount of idle resources when the recovery began.

The dramatic slowdown in productivity growth is the root cause behind the major economic developments during the last 15 years. First, as discussed earlier, the competitive position of the United States in world markets has declined dramatically since the early 1970s, causing sharp declines in the U.S. share of worldwide production in most industries; gigantic trade deficits after many years of surpluses; and, our shift from being the world's largest creditor to its largest debtor in a matter of a few short years. This change in relative competitiveness primarily reflects a shrinking of U.S. advantages in technology, product quality, and mostly, productivity. In industry after industry, the gap in these areas has been narrowed by foreign competitors — in some cases, U.S. companies have actually fallen behind. And, most significantly, the slow growth in productivity in the United States made it relatively easy for foreign competitors to catch up.

Second, and directly related, real wages have essentially stagnated since the early 1970s, following an average annual post-war increase of 2.5% until then. Although partly due to oil-caused inflation in the 1970s, the major factors have been the widespread wage restraint and the loss of many high-paying jobs (while most of the newly created jobs are lower-paying) that resulted from sluggish productivity growth and deteriorating competitiveness. This slowdown in real wages has meant that an increasing number of families have had to rely on a second income, cutting savings, and/or going deeper into debt in order to improve or just maintain their living standards.

A substantial acceleration in productivity growth is essential if these trends are to be reversed, if the tradition of rising real wages and living standards in this country is to be restored, and if the current expansion partly created by a massive debt buildup and by rising labor force participation rates is to be continued. Higher productivity is also necessary if we are to address the enormous unmet needs that have been building, such as dealing with the drug problem, finding a cure for aids, etc. — only in a more productive society can we have the resources to meet these needs.

This, in my view, will require a major national effort. Unfortunately, the opposite seems to be occurring — not only are these unfavorable trends not receiving adequate attention, but if anything, a sense of complacency seems to have developed because of the decline in the trade deficit in early 1988. However, as discussed earlier, the trade turnaround has been small at best, and is primarily due to the weak dollar and cost cutting in U.S. industry (and thus is occurring at the expense of living standards) rather than reflecting any major change in fundamental competitiveness. Without such a change, real wage gains will continue to be weak, or nonexistent, at a time when an increasing share of U.S. incomes will be needed to service the enormous and still growing foreign debt — this combination would further jeopardize living standards in the future.

What is particularly disturbing is that the growth in manufacturing productivity has begun to slow in the last two years, following a surge in the mid-1980's. But this is not surprising since the early surge partly reflected widespread outsourcing of various job functions (and thus was not accompanied by a significant acceleration in economy-wide productivity growth), as well as many one-time factors such as plant closings and corporate staff layoffs, rather than ongoing improvements in manufacturing efficiency. What is needed is to produce a sustained period of accelerated growth in productivity, not just one-time adjustments, especially since the gains in efficiency in many of the countries we compete with still exceed that being experienced in this country. And, since the basic factors which influence long-term productivity are not improving, this is not likely to take place unless major changes in government policies, and in our priorities as a nation, are implemented.

That is why I and a number of colleagues at Rebuild America, including Nobel Laureate Robert Solow, recently proposed a comprehensive strategy to boost productivity through increased private and public investment in physical and human capital. Essentially, we believe that the only clear way to produce the sustainable, ongoing increases in productivity that are needed is to increase our basic research, to embody new technology more quickly in our production facilities through a higher investment rate and a more long-term focus, and to educate and train our workers more effectively. Unfortunately, the recent evidence suggests that without a government-led national focus, adequate improvements may not take place, especially since the solutions, like the causes, must be multidimensional. Washington must play an important role in the process by mobilizing the private and public sectors on behalf of such an "investment economics" that raises the national saving rate, provides tax incentives for productive private investment, and boosts public investment in the workforce and cutting-edge industries of the 1990s.

Specifically, Washington should:

1. Set goals for savings, investment, R&D, educational quality, etc.;
2. Focus attention on the importance of productivity in every segment of the economy, and help create an environment that favors real investment over speculation and financial transactions, and that moves us away from an excessive short-term focus toward a more long-term orientation.
3. And, most of all, promote policies which create the best possible business environment by:
    - a. Reducing the budget deficit in order to increase national savings. In my judgment it will be impossible to achieve the goal of a satisfactory gradual deficit reduction without some tax increases — these tax increases should be consistent with the following objectives: (a) they should limit the negative impact on our competitiveness; (b) they should be phased in gradually so as to dampen the economy very slowly; (c) they should not make the tax structure any less regressive than it has already become in recent years. There has already been a definite shift in the tax burden away from the upper income groups to those in the middle and lower groups, primarily reflecting the fact that upper income groups benefitted more from the 1981 tax cuts than other groups; the increased reliance on highly regressive Social Security taxes; and other such factors. I would be strongly opposed to the enactment of a value-added tax, because of its highly regressive nature, because its impact on international trade is overstated, and because the lesson of recent years is that the tax structure has a much smaller impact on personal savings than many others suggest. Furthermore, it would be inflationary at a time when inflation concerns are already high.

b. Developing policies to ensure that the resulting increase in national savings is used wisely; e.g., for more productive investment and more research and development by the private sector with a long-term focus.

c. Adjusting spending priorities and the tax structure to promote future investment and growth. With regard to trying to shift the focus of the private sector more toward long-term investment, I would suggest two changes among those that should be considered. First, a sliding capital gains tax which would substantially increase the tax rate on short-term gains (say 50%), and gradually scale it back to a much lower rate (say 10%) on long-term gains. This would discourage some of the speculation and excessive LBO activities, and shift the focus of investors more toward the long-term. Second, eliminating the bias in the tax code favoring debt over equity should also be considered, but in a way that does not reduce overall tax revenues.

d. Bringing industry, government, labor and universities together for joint research and other cooperative efforts when appropriate.

e. Forging government-business alliances to address specific economic problems.

f. Reducing LDC debt to make those countries viable markets for U.S. products again.

g. Being more forceful in opening up foreign markets to U.S. goods.

h. Reversing the declining quality of education, especially in mathematics and science, in order to increase the skill levels of the labor force.

I believe very strongly that the appropriate course of monetary policy in the years ahead depends very heavily on what the new Administration and Congress do regarding the deficit. Right now stabilization policy rests almost completely on the Fed at a time when we have become so dependent on foreign capital that the Federal Reserve's control over monetary conditions and interest rates has been considerably weakened. In effect, they have been put in a box with severe constraints. In my view, any credible program to reduce budget deficits should be accompanied by a gradual easing of monetary policy to bring interest rates lower — this is likely to be produced by the market itself, but can be augmented by the Fed.

Representative HAMILTON. Mr. Rahn, please proceed.

Mr. RAHN. Thank you very much.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE

Mr. RAHN. After listening to my colleague, I understand why policymakers are often confused when they listen to economists because Larry Chimerine and I have a very different sort of view of the world.

I guess I'm glad I'm not in your shoes having to make a decision about what to do. We at the chamber are much more optimistic about our economy's future. We are now fortunate to be in the 75th month of our record peacetime economic expansion. The economy has performed better over the last 6 years than virtually any forecaster predicted, including us.

And I think the best news is the economic expansion is likely to continue at reasonably good rates without a buildup in inflation.

The Council of Economic Advisers predicted economic growth for 1989 at 3.5 percent; in 1990, at 3.4 percent.

We agree and we are predicting economic growth in 1989 of 3.5 percent; in 1990, of 3.3 percent.

In the past several years, both the Council of Economic Advisers, and particularly Mr. Sprinkel and we at the chamber have been accused of rosy scenarios. It seems each year we come out with our forecast, we are accused of being unduly optimistic.

So I went back and looked at our projections for the succeeding year, looking at our October forecast and that of the blue chip panelists, and those of the Council of Economic Advisers and the other leading government agencies.

What I found was somewhat surprising. At the chamber the last 6 years, we were too pessimistic in 4 of those years and in only 2 of the years were we too optimistic.

And, on average, we were too pessimistic. The same pattern held true for the Council of Economic Advisers. And for the consensus of the blue chip indicators, the blue chip was more pessimistic on average than we were. And of the 41 economists, surveyed consistently over the last 6 years by the blue chip indicators, our forecast accuracy came in fifth.

There were four who were more accurate than we, and they were all more optimistic. And the majority was quite a bit more pessimistic.

Given this sort of disparity in views, I'm sure you are probably asking how can forecasters, both private and government, looking at the same statistics, come to such different conclusions about the future course of the economy?

We find the following:

First of all, policy mistakes, not inherent instability in free markets, are the reason economic expansions do not last.

History shows that policy mistakes are primarily responsible for periods of stagnant or falling economic growth and bouts of inflation. Politicians and central bankers persist too long in flawed policies and then overreact to their mistakes in an attempt to correct them.

Excessive money supply growth is the cause of inflation. In fact, I need to commend Chairman Greenspan. I noticed in his testimony yesterday—it is the first time that I've ever noted a Chairman of the Federal Reserve to state correctly, that inflation is a monetary phenomenon.

I think this statement is a step forward to help other people face realities.

The period of time between changes in the growth of money supply and the changes of the rate of inflation can be as long as 2 years. The current record expansion is different from earlier expansions because the rate of inflation has not accelerated.

However, today's rate of inflation of about 4.4 percent is too high and should be gradually reduced by maintaining a steady and predictable rate of money supply growth.

The major source of controversy regarding the prospects for the economy in the 1990's comes from different assessments of the economy's noninflationary growth potential. And this is where Mr. Chimerine and I would have our major disagreement.

Many of the more pessimistic analysts, we believe, hold to outmoded economic theories that are not supported by the evidence, leading them to erroneous conclusions that the same amount of economic growth that has characterized the first 6 years of this record economic expansion, cannot be continued without severely accelerating inflation.

Throughout the economic expansion, growth potential has been increasing due to the enactment of policies that have unleashed the supply side of the economy. Differences in long-term estimates of growth potential are closely tied to varying estimates of productivity growth.

Both the Congressional Budget Office and the Fed project low-growth potential because they believe productivity growth will fall substantially below its long-term trend in the future.

In the near term, many analysts expect the Fed to maintain slow credit growth and to increase interest rates, which will lead to recession.

Their reasoning is: current Fed policy is a significant threat to economic growth, and that is evidenced by the humped-yield cure of interest rates. If short-term rates are increased further, the yield curve will invert, a phenomenon that always precedes a recession.

We believe many members of the Fed will understand the perils inherent in a prolonged high-interest rate policy and, thus, will avoid the yield curve inversion.

If the Fed stops attempting to fine tune the real economy, interest rates, especially short-term rates, will begin to fall as credit markets stabilize.

In the absence of continued Fed intervention, if the Fed chooses to maintain the correct policy course and the Congress refrains from enacting new taxes, real growth in 1989 and 1990 should continue above the 3 percent, a rate below our long-term, noninflationary growth potential estimate.

The rate of inflation should fall in 1989 and 1990, not because of the Fed's recent attempt to fine tune the economy by raising interest rates, but rather because the rate of money growth has slowed since early 1987.

Now, turning to the budget deficit, the deficit can be reduced without new taxes if Congress adopts a fair and flexible freeze. The fair and flexible freeze, if enacted, will work to wipe out the deficit by 1993. Let me touch on that for a second.

Right now, Federal revenues under the current tax structure are increasing about 7 to 8 percent per year. Inflation is rising roughly at a 4-percent rate.

Clearly, if you hold the growth in Federal spending to a little more than the rate of inflation—let's say 5 percent—the budget will indeed balance without a tax increase.

Congress has shown in some recent years the ability to do this. I see no reason why they ought not to in the future, particularly since they no longer have the pressure of doing a defense buildup.

And the key thing is to keep the economy growing. Obviously, none of us know the future with certainty. All of us have much to be modest about.

With the strong growth in domestic investment, the aging and increasing skill level of the work labor force and the rapid rate of technological change, our belief is that productivity growth will be higher than the CEA estimates, and there is where the next surprise will be, is higher productivity growth rates.

Also given the large amount of new investment coming downstream in those areas with high-capacity utilization, this should reduce the fears of shortages and encourage the Fed to reduce interest rates, particularly in areas such as paperboard and feedstock chemicals which have had high-capacity utilization rates.

There is a lot of new capacity coming in these areas, and I think that is going to alleviate concern about the tightening of supplies.

In sum, economic expansions do not die of old age. They die as a result of policy mistakes. And we have not seen any policy mistake today of sufficient magnitude to put us into recession.

We believe that if Congress avoids increases in taxes and if it avoids hobbling the economy with major new, extensive regulation, and if it reduces the rate of growth of Federal spending to a little above the rate of inflation, and if the Fed does not have an overly restrictive monetary policy, expansion should continue at a noninflationary, or even a reduced inflationary, rate of about 3 percent real economic growth for the foreseeable future.

And, again, just to touch on the notion of the deficit, the deficit has been coming down in real terms. Clearly, we were all concerned during early and mid-1980's when the deficit was increasing as a percentage of GNP—in particular the interest outlays, when you had a growing increase in these deficits.

But, in the last 3 years, the deficits have been headed down as a percent of GNP. And this year, in fiscal 1989, the amount of deficit will be a bit higher. But a lot of the added expenditures are one-time hits. Some are due to budgetary—I hate to use the word "games,"—but I think that is what happened when we shoved some of last year's spending into this year's budget, for example, with the S&L problem.

But, the S&L problem is basically a one-time hit in the economy and we ought not to have a permanent tax increase to offset the mistakes of the past.

We are better off taking a larger hit in this fiscal year and getting back on to the Gramm-Rudman path beginning in fiscal year 1990, which we believe is indeed doable.

Again, even with a 3-percent rate of growth, which is considerly lower than we have had over the last 6 years, and with modest spending growth rate restraint, we would be at about a balanced budget in 1993.

If economic growth was a bit slower, or congressional spending was a bit higher, it might not balance until 1994 or 1995. But, clearly, this kind of route is preferable to a major tax increase, which we believe could derail this expansion.

Thank you, Mr. Chairman.

Representative HAMILTON. Thank you, Mr. Rahn.

[The prepared statement of Mr. Rahn follows:]

PREPARED STATEMENT OF RICHARD W. RAHN

ON

THE OUTLOOK FOR THE AMERICAN ECONOMY IN 1989 AND 1990

I am Richard W. Rahn, Vice-President and Chief Economist of the U.S. Chamber of Commerce. On behalf of our 180,000 member businesses, trade associations, and state and local chambers of commerce, thank you for the opportunity to present our thoughts on the economic outlook and proper fiscal and monetary policies in the coming years.

At the outset, let me commend the members of the President's Council of Economic Advisors (CEA) for their outstanding report, the *1989 Economic Report of the President*. In that report, the CEA gives an excellent account of the economic progress we have experienced since our longest peacetime expansion began at the end of 1982. The report also addresses the fundamental concerns that face policy-makers today. The CEA presents a clear, understandable view of where it expects the economy to go if the correct policies are adopted by the new Administration and the new Congress. The Chamber concurs with the Advisors, who foresee a continuation of the economic expansion and an opportunity for annual real growth above three percent. The report is an excellent starting point for discussions about the future course of the economy.

However, the Congressional Budget Office (CBO) and the Federal Reserve Board (Fed) disagree with the CEA over the prospects for economic growth. Some members of the Fed claim that current economic growth is too high and have convinced other Fed members to be actively engaged in a deliberate policy of economic slowdown. We believe this policy is an overreaction to fears of accelerating inflation. And, CBO budget projections, based in part on a belief that the Fed will persist in a high interest rate policy, use such a low estimate of economic growth that the CBO baseline deficit does not fall fast enough to meet Gramm-Rudman targets without draconian spending reductions or destructive tax increases.

Some private forecasters disagree with the CEA's projections to such an extent that many predict a serious economic slowdown in 1989 and 1990, either from excessively tight Fed policy or from other forces at work in the economy. The question we face is: how can forecasters, both private and governmental, looking at the same statistics draw such different conclusions about the future course of the economy?

We find the following:

- Policy mistakes, not an inherent instability in free markets, are the reason economic expansions do not last. History shows that policy mistakes are primarily responsible for periods of stagnant or falling economic growth and periodic bouts of inflation. Politicians and central bankers persist too long in flawed policies and then overreact to their mistakes in an attempt to correct them.

- Excessive money supply growth is the cause of inflation, but the period of time between changes in the growth of the money supply and changes in the rate of inflation can be as long as two years.

- The current record expansion is different from earlier expansions because the rate of inflation has not accelerated. However, today's rate of inflation of about 4.4 percent is too high and should be reduced gradually by maintaining a steady and predictable rate of money supply growth.

- The major source of controversy regarding the prospects for the economy in the 1990s comes from differing assessments of the economy's non-inflationary growth potential.

- Many of the more pessimistic analysts hold to outmoded economic theories that are not supported by the evidence, leading them to the erroneous conclusion that the same amount of economic growth that has characterized the first six years of this record economic expansion cannot be continued without severely accelerating inflation.

- Throughout the economic expansion, growth potential has been increasing due to the enactment of policies that have unleashed the supply-side of the economy.

- Differences in long-term estimates of growth potential are closely tied to varying estimates of productivity growth. Both CBO and the Fed project low growth potential because they believe productivity growth will fall substantially below its long-term trend in the near future.

- In the near term, many analysts expect the Fed to maintain slow credit growth and to increase interest rates which will lead to a recession. Their reasoning is: current Fed policy is a significant threat to economic growth, as is evident by a "humped" yield curve. If short-term interest rates increase further, the yield curve will invert, a phenomenon that always precedes a recession. We believe that many members of the Fed understand the perils inherent in a prolonged high interest rate policy and thus will avoid yield curve inversion;

- If the Fed stops attempting to fine-tune the real economy, interest rates, especially short-term rates, will begin to fall as credit markets stabilize from the absence of continual Fed intervention.

- If the Fed chooses and maintains the correct policy course, and if Congress refrains from enacting new taxes, real growth in 1989 and 1990 should continue above 3 percent, a rate below our estimate of long-term non-inflationary growth potential.

- The rate of inflation should fall in 1989 and 1990, not because of the Fed's recent attempt to fine-tune the economy by raising interest rates, but rather because the rate of growth in money supply has slowed since early 1987.
- The budget deficit can be reduced without new taxes if Congress adopts a fair and flexible freeze. The fair and flexible freeze, if enacted, will work to wipe out the budget deficit by 1993.

POST-RECESSION FORECASTS

Before I present our outlook for the next two years and the policies that should be adopted, let me briefly review the forecasting history of leading analysts from the beginning of the expansion. It is important to note that much of the debate over appropriate policies that the government should now adopt is based upon different assessments of the economic future. Choosing among the wisdom inherent in the different forecasts is a vital first step for today's policy-makers.

Estimates of the economy's long-run growth potential are critical, because economic growth is so important in determining the path of projected budget deficits and because it appears the Fed is unwilling to allow the economy to grow at rates that greatly exceed their growth potential estimates. Since 1983, real GNP growth varied from 2.8 to 6.8 percent, measured on a year-over-year basis.

Since 1983, the average forecasts of the panel of private economists who contribute to the Blue Chip Consensus underestimated actual GNP growth four times and overestimated it twice. The Blue Chip Consensus misestimated overall economic growth by an average of 0.7 percentage points, a good performance by most standards.

Similarly, Chamber forecasts underestimated actual GNP growth four times and overestimated it twice. However, the Chamber's forecasts have consistently been more optimistic and thus slightly more accurate than those of the Blue Chip Consensus. Of the 41 private forecasters who have been contributing their forecasts to Blue Chip since 1983, the Chamber is one of only five forecasters who was more accurate than the Blue Chip Consensus in forecasting actual economic growth.

Blue Chip forecasters include numerous pessimistic analysts who have projected economic growth far below actual growth for many years. Since 1985, they have brought the consensus forecast down, even though actual economic growth has been on the rise.

Moreover, the more optimistic participants in the Blue Chip panel tended to have more accurate forecasts of economic growth. If the experience of the last six years is a useful guide, policy-makers should pay as much or more attention to the optimistic forecasters than to the Blue Chip Consensus.

PESSIMISM INCREASES AS THE EXPANSION MARCHES ON

One explanation for the increased pessimism of some analysts has been, paradoxically, the record length of the current expansion and increasing rates of growth in the last three years. For example, in 1985, the CBO projected real GNP growth into the 1990s at a 3.5 percent rate. More recently, as actual growth rates have risen, the

CBO projection of long-term growth has fallen to the point where it projects a real growth rate of only 2.3 percent in the 1990s.

One reason for CBO's increased pessimism is that the unemployment rate has fallen far below what the CBO projected in 1985. The CBO appears to believe that this drop brought the economy closer to non-inflationary potential GNP. The CBO is now more pessimistic because it clings to ideas about the economy that history has shown do not make sense. It believes, like many others, that falling unemployment and, for that matter, rising growth and employment, cause prices to rise by bringing the economy to the brink of a mythical full employment barrier.

The stagflation of the 1970s and the expansion of the 1980s yield ample evidence that these notions do not make sense. In the 1970s, both inflation and unemployment rates rose. In the 1980s, we have experienced falling unemployment rates, rising employment and above trend real GNP growth and, at the same time, a decline in the rate of inflation. Most recently, inflation has stabilized at about 4.4 percent while the vital signs of the economy remain strong. Factory orders are up; production is strong; employment growth continues unabated; and productivity is on the rise. Domestic and foreign demand remain high enough to boost sales, and sellers are encouraged to add to their inventories in anticipation of even greater sales. And the economy's capacity to produce continues to expand to accommodate increased demand without bottlenecks and overheating.

For the past three years, the pessimists have insisted that the end is near; that overstimulation and overheating of the economy would lead to runaway inflation. And for three years they have been emphatically wrong. As this expansion continues, more and more analysts are recognizing that it is different from those that preceded it. Inflation is still less than in the period of recession that preceded the expansion. For the first time since World War II, both inflation and unemployment have come down in tandem.

GROWTH POTENTIAL HAS INCREASED DUE TO CORRECT POLICIES

Throughout this expansion, pessimistic forecasters have underestimated the extent to which non-inflationary growth potential increased from the adoption of correct economic policies. These policies were aimed at building a solid, permanent foundation for growth by invigorating the private sector. Specifically, marginal tax rates were lowered thereby increasing the incentives to produce and find work. Economic regulation was reduced thereby removing barriers to production. These policies encouraged people to start new businesses and allowed consumers to reap the benefits of added free market competition.

By expanding opportunities and increasing private incentives, we have created an economy that is more resilient to unanticipated shocks such as the 1987 stock market crash and last year's drought. Similarly, the new economic policies adopted since 1981 have allowed the economy, at least for a while, to overcome policy mistakes. Last year the economy grew by 3.8 percent in spite of concerted efforts by the Fed to slow it down.

By promoting prosperity in the private sector and by reversing the austerity policies of the 1970s, we have unleashed the economy to rack up record employment gains. Selection of the right policies has transformed the economy from a high inflation, high unemployment and high interest rate misery monster into a stable, non-inflationary growth machine.

The success of this non-inflationary expansion has been guaranteed by restraint in monetary policy. By eliminating inflationary monetary policy we redirected resources out of unproductive hedges against inflation into productive uses.

RECENT FED POLICY HAS BEEN BASED ON UNDERESTIMATES OF GROWTH POTENTIAL

In earlier expansions, the Fed created the illusion of prosperity by adding too much money to the economy. Those expansions stopped when inflation became too heavy a burden to bear and policy-makers demanded that the Fed intervene to check inflation. Looking objectively at the history of past expansions and contractions, one must conclude that inflation resulted from overstimulative Fed policy, not "excessive growth" in the real economy. History also reveals that recessions follow when the Fed overreacts to the inflation it produced in the first place with high interest rates and sudden reductions in the growth rate of money.

Recently, the Fed appears to have gone to the other extreme. Because the Fed has been underestimating the economy's long-run growth potential, it has ratcheted up interest rates in anticipation of future inflation. The irony is that instead of overreacting to their own past errors, this time the Fed appears to be overreacting in anticipation of future inflation for which there is no observable source. Since late 1986, growth in the money supply has not been inflationary. Yet, in the past year, the Fed intentionally has pushed up short-term interest rates over 250 basis points.

Several short-term interest rates, especially one and two year Treasury bills, have moved above long-term rates. Fed policy has created a yield curve that is "humped" and current policy threatens to create an inverted yield curve. An inverted yield curve exists when the shortest term interest rate, the three month Treasury bill, exceeds the longest term rate, the thirty year Treasury bond, a phenomenon that has preceded and lasted far into every recession in the last 30 years.

In the last several weeks, we have been heartened by the Fed's openness in discussing a variety of views. We believe that many members of the Fed now recognize the economy's true growth potential exceeds earlier estimates. Our economic forecast is based on the belief that the Fed will now retreat from its ill-fated efforts to fine tune economic growth.

GROWTH POTENTIAL ESTIMATES

Macroeconomics remains the least understood and most controversial subfield of the discipline. Regardless of their point of view, however, most economists generally agree upon a general rule of thumb by which to estimate non-inflationary growth potential. We usually add the growth rate in the labor force to the growth rate in productivity, a method that is called Okun's Law. The CBO and the Administration use this same method, yet they come up with two different measures of growth potential. The CEA report indicates a 3.2 percent long-term, non-inflationary growth rate potential, while the latest CBO budget report accepts a lower, 2.3 percent long-term growth potential estimate.

The source of these different growth potential estimates is largely a disagreement over projections of productivity growth, since estimates of labor force growth vary slightly, if at all. Non-farm business sector productivity has increased at an average annual rate of 1.8 percent over the course of this expansion. CBO forecasts that the rate of growth in productivity will decline in the years ahead to about 1.0 percent. By way of comparison, CEA estimates that overall productivity improvement is expected to return to 1.9 percent, the long-term trend in overall productivity experienced from 1948 to 1981. We agree with the CEA that productivity growth will increase as this expansion continues, and we have reason to suspect that CEA estimates are somewhat conservative. The 1.9 growth trend the CEA adopts reflects the low productivity growth of the 1970s. Typically, in periods of long term economic expansion, such as we experienced during the 1960s, productivity growth tends to average above its long term trend. For example, during the 1960s, non-farm business productivity growth averaged 2.5 percent.

FORECASTS AND FED POLICY

Many analysts believe that the Fed will persist in fighting inflation by pushing short-term interest rates up further in 1989. They argue that if the Fed follows such a policy, the economy will experience a slowdown of such proportions that the growth rate in the latter half of 1989 will be low, if not negative. While we are concerned about the high interest rate policy the Fed has been pursuing (we have lowered our 1989 growth forecast from 3.7 percent in October to 3.5 percent because of the severity and length of Fed high interest rate policy), we do not expect it will continue. If it does, a major economic slowdown at some point will become inevitable.

Since the middle of last year, growth rates in monetary aggregates have almost been cut in half, reflecting Fed policy to restrict credit and raise interest rates to slow down the economy. In that time, however, inflation has not accelerated as was feared. Today, prices are rising at the same rate as they did in 1987, about 4.4 percent. Moreover, the Fed has regained control over money supply growth since the beginning of 1987 which should lead to a reduction in the rate of increase in inflation in 1989 and 1990.

Regardless of what this year's monetary policy turns out to be, the inflation rate for 1989 already is set. It will be determined by past increases in money supply, which can now be characterized as having been subdued. Further Fed tightening merely risks gains in employment and real economic growth in 1989, a cost we believe the Fed is not currently willing to accept while inflation is stable. Yet we also recognize that inflation is too high. But to bring inflation down over the long term, the Fed should concentrate on pursuing non-inflationary monetary policy as it has with brief interuptions throughout most of this expansion rather than attempting, as it has recently, to counteract what it perceives to be inflationary forces in the real economy. It is important to recall that the rise in inflation experienced in early 1988 was a direct consequence of rapid money growth in 1985 and 1986 that was engineered by the Fed to drive down the value of the dollar on international currency markets. In other words, the one brief acceleration in inflation experienced during this expansion resulted from mistaken Fed policies, not excessive economic growth.

LONG-TERM INFLATION CONTROL

We predict that in 1989, GNP will grow by 3.5 percent, the Consumer Price Index will rise at a lower rate than in 1988, 3.9 percent, and that the economy will experience falling unemployment rates to as low as 5.0 percent. Short-term interest rates on three-month Treasury bills will fall to as low as 7.4 percent. In 1990, we predict that economic growth will be 3.3 percent, inflation will be 3.3 percent, unemployment will fall to 4.8 percent, and short-term interest rates be near 7 percent.

Some analysts would argue, however, that increasing growth and tight monetary policy are inconsistent with falling interest rates. But, interest rates currently are artificially high because the Fed has shocked credit markets with greater restriction on credit than was anticipated at the beginning of the year. As a result, anticipations have changed and short-term interest rates contain a new premium.

The new premium can be called a "Fed premium" based upon expectations by market participants that the Fed will continue to manipulate the amount of credit. Manipulation of liquidity and interest rates by the Fed adds considerable risk and uncertainty to credit markets. The Fed premium keeps real interest rates much higher than necessary.

If the Fed stops attempting to fine-tune the real economy, we believe the Fed premium would disappear gradually and interest rates would fall even though the Fed's monetary policy might appear to be "tight."

FISCAL POLICY AND THE BUDGET DEFICIT

Most analysts worldwide are looking at the manner in which the new Congress and the new Administration will deal with the budget deficit. We support a fair and flexible freeze to meet the Gramm-Rudman targets and to balance the budget by 1993. The flexible freeze targets can be achieved even at below-average rates of economic growth. Obviously, the higher the growth rate, the easier it is to hit the flexible freeze targets.

Tax revenues are projected to increase at 7 to 8 percent per year over the next five years, assuming inflation at about 4 percent per year. Thus, if Congress holds the growth in federal government spending to a little more than inflation, the deficit will continue to fall toward zero in 1993.

The fair and flexible freeze approach emphasizes the importance of maintaining a pro-growth economic policy. Tax increases reduce economic growth by destroying incentives to produce, save and invest and thus are counter-productive to any effort to reduce the deficit. In fact, tax increases may lead to an increase in the deficit as they have in the past when federal expenditures have risen by much more than tax increases.

This has occurred even when the purpose of a tax increase was to reduce the deficit. Hence, the worst possible thing Congress could do is to increase taxes.

The fair and flexible freeze was first analyzed using 1988 and 1989 baseline spending projections. Since the Gramm-Rudman deadline of October 15, 1988, projected spending in 1989 has increased significantly. Spending in 1989, for example, is now projected to exceed Gramm-Rudman approved spending by $15 billion. Part of the increase in FY 1989 spending is due to high interest rates promulgated by unnecessary Fed policy. Other significant spending increases that occurred after the October 15, 1988 Gramm-Rudman trigger had safely passed involve the Federal Savings and Loan Insurance Corporation and defense spending.

We believe that the additional $15 billion or so new spending placed in the FY 1989 budget through the "Gramm-Rudman window" violates the spirit of the law. In order to keep faith with the American public, we recommend that Congress take action before the end of FY 1989 to bring the budget into conformity with the Gramm-Rudman targets.

CONCLUSION

The economy should continue to grow in 1989 and 1990 if major policy mistakes can be avoided. Congress and the new Administration must reduce the rate of growth in government spending to a rate only slightly higher than the rate of inflation, resist any tax increases and adopt the fair and flexible freeze to assure Americans that a workable solution to the budget deficit is implemented. In addition, the Fed should recognize that inflation is a monetary phenomenon with long lags and hence it should not attempt to fine-tune the economy in an effort to counteract what it perceives to be mistaken fiscal policy. The Fed would be well advised to adopt a set of price and quantity monetary growth rules that permit the money supply to grow at a known, predictable, non-inflationary rate, no more, no less.

Representative HAMILTON. Mr. Sinai, please proceed.

STATEMENT OF ALLEN SINAI, CHIEF ECONOMIST, THE BOSTON CO.

Mr. SINAI. We want to maintain the economy without accelerating inflation. This is the key to the future because the economy has moved ever closer to full employment.

For much of the 1980's, dealing with policies to keep the economy growing without generating higher inflation was irrelevant in the aftermath of the recessions of the eighties. There was a great deal of room to grow and no real problem on full employment in the foreseeable future.

But, times have changed. As the chart in the prepared statement suggests, by one measure, the "gap," the difference between estimated potential real GNP and actual real GNP, the gap is no more. From a shortfall of over 11 percent in 1982, the gap has been eliminated and now currently running in reverse.

That is to say, actual real GNP is above potential real GNP by approximately $50 billion. The estimate of potential real GNP growth that we carry is 2.6 percent per annum. This is below historical trend, but a little bit above what the Federal Reserve has been suggesting in pronouncements that targeted real economy growth should be 2 to 2.5 percent.

The chart is interesting because it shows that for the first time since 1972-73, the late 1960's and the early 1960's that our economy is running above its potential, measured in this way.

Other measures say similar things. The unemployment rate is at 5.3 percent, a 14-year low. In comparison, the overall capacity utilization rate is 84.3 percent. We cannot say the economy is at complete full employment, but all measures together indicate that we are in a full-employment zone, approaching the limits of capacity in product, labor, and financial markets.

In a situation where there is near full employment and accelerating demand—full inflation can be expected. Indeed, these pressures and trends, if they should continue, would ultimately constrain real economic growth, cause the Federal Reserve to raise interest rates sharply, pose difficulties for the economy, domestically and internationally.

The core ingredients of any economic downturn always have been capacity restraints, high inflation, and a need for the central bank to raise interest rates to slow the inflation.

The central bank always has had to impose high interest rates in such a situation, with no help on the fiscal side.

I think we are in the vicinity of a possible turning point in our expansion. It is very hard to know exactly when. In our focus, we suggest that the first half of 1990 would be the most likely time and one of mild recession. But, a major slowdown or recession does not have to happen.

There are ways around the full-employment zone, to finesse the demand-pull inflation that is generated. And, most of them lie in policy here in Washington.

The forecast that we carry shows continued above-potential growth in the real economy through midyear, with inflation accelerating into a 5- to 6-percent range as a byproduct. Additional necessary restraint by the central bank is required in the absence of significant progress on reducing Federal budget deficits, with interest rates rising into the summer; then a slowdown late this year and a mild recession in the first half of next year. The dollar would be weaker later this year and the United States would not be able to recapture a strong, competitive position in the world economy with the higher deficits that would occur as a consequence of a slowdown. Relatively slow economic growth, high inflation, and an unemployment rate in excess of 6 percent would characterize 1990 and 1991 as subpar years.

The forecast—really a scenario—there is no concrete rule that says that it has to happen. It is based on current conditions and best guesses on policies in Washington.

There is no overwhelming reason why business expansions must evolve into a downturn, provided that the appropriate policy settings are made in Washington at the appropriate time.

Let me turn to some details of how we see the economy and its progression over this year. In the here and now, in the real economy, it is performing quite well. Real economic growth, after accounting for the effects of last year's drought, rose a little over 3 percent in the second half and showed good momentum coming into the new year.

The growth is solid. There is no particular excesses or imbalances in the internal mechanisms of the economy. The industrial sector has come on strong, and employment and incomes are rising nicely.

On the negative side, inflation is too high for comfort but accelerating gradually so far. Productivity growth is low and unit labor costs are rising. The internal and external deficits are too high, threatening to mortgage the future of the U.S. economy well beyond the next decade.

In 1988, the economy became more well balanced, for the most part driven up by a sharp improvement in real net exports, a strong business sector, and supported by good consumer spending.

Regionally, the economy is better balanced with previously weak areas, such as the Midwest, now doing well, and previously booming areas like the Northeast now showing up weaker.

The traditional signs of a slowdown or downturn are not present at this time. That suggests that the expansion can continue through this year. I would repeat that any slowdown we see or mild recession would be in 1990, not in 1989.

The role of the central bank in the forecast—the assumption on the central bank follows on last year's strategy.

The strategy last year was to use small doses of monetary restriction to gently nudge economic growth lower. The reported GNP figures were 2 to 2.5 percent real growth in the second half. But I think the Fed is too wise to believe those numbers, since the drought effects were arbitrarily spun across the year. Once taking into account the drought, 3-percent growth, which is in excess of our potential, was the correct figure.

Inflation ended up higher than the Federal Reserve wanted in the second half. So, the Fed's strategy has not worked.

The central bank, we assume, will continue a similar strategy this year on the kind of economic projections that we carry, leaning more against inflation in the 5- to 6-percent range, because that is too high and above the threshold level of the Fed.

After interest rates rise more, then the real economy can reach a 2 to 2.5 percent growth rate or below. The risk is overshooting. The Federal Reserve is well aware of that, but so have other central banks been aware of possibly overshooting. That does not stop overshooting on the downside from coming about.

As for the budget, the budget last year was stimulative on the full-employment or unified budget basis. The budget deficit grew and added to the private sector stimulus in an economy that was getting ever closer to full employment.

Our projections on the deficit in fiscal year 1989 and fiscal year 1990 do not agree with nor offer much relief on the budget deficit stimulus in the economy in fiscal year 1989 projections, which is approximately $165 billion on the unified budget deficit. This is only a little bit above the administration's budget, $161.5 billion, which is $19 billion higher than OMB estimated just 3 months ago.

And for fiscal year 1990, $175 to $176 billion is the estimate. The estimates that we carry reflect higher current services budget deficit estimates and much less help from economic growth and interest rates than is seen by the administration.

Higher defense and agricultural spending, more spending on the thrift bailout problem and a plug factor for items such as nuclear waste cleanup and infrastructure outlays for the unknown on the expenditure side, which is more likely to be higher than lower.

For the economy itself, the figure for 1989 looks good, 3.3 percent year over year and 3 percent fourth quarter to fourth quarter. But those are recorded numbers and one must subtract approximately one-half percentage point for the help from the reversal out of the drought, with the reported growth to be up from 5.5 to 6 percent.

I would expect a better economy than typically thought in the first half, then higher, perhaps higher than expected interest rates to slow the economy down by 1990. A mild recession is forecast in the first half of 1990.

So, I think the question to be asked is whether one should follow this forecast or the more optimistic projections of the other panelists. The question is, how to sustain the expansion and to avoid any slowdown, any regeneration of inflation and too high interest rates coming from the Federal Reserve tightening?

The answer is a textbook answer:

Cut the Federal budget deficit now. It probably is too late for fiscal 1989.

The key to sustaining the expansion lies in the Federal budget. Slower growth achieved by fiscal restraint can set up conditions to actually make the expansion last longer rather than permitting the economy to move along given the current prospects for the budget deficits.

At a time when the economy is close to full employment, excessive Federal budget deficits are a double-barreled problem. First, the budgets that would remain under full employment, now estimated to be approximately $130 billion, stimulate the economy along with the private sector. This creates a demand-pull acceleration of inflation.

Large budget deficits, when the economy has great slack, are a great plus. That was the story of the 1980's and the great 1980's expansion. Then, the budget stimulated growth, reducing unemployment without an accompanying accelerating inflation.

That is not the case now. Now the deficits are deadly, since we are so close to full employment.

A second problem on deficits is the debt that accumulates with continuing Federal budget deficits and interest charges and the burden of interest charges that debt brings.

At the same time, the deficits and trade indebtedness produce a large supply of dollars that drives the currency lower, which may help exports and the industrial side of the economy, but can add to inflation, especially when the economy is near full employment. And this is dangerous when inflation is already running at 4.5 percent.

The assumption we carry on the budget deficit process this year—because we have to make such an assumption in order to do a forecast—is that Congress and the administration reach agreement on approximately $30 to $35 billion of deficit reductions for fiscal year 1990, late this summer or early fall, with about $25 billion of that bona fide, or real.

The program assumed is an $8 billion reduction in defense spending, essentially a reduction in the growth of defense spending at or a little below the rate of inflation, $12 billion reductions in nondefense spending, and a $10 billion gasoline tax increase.

This is the scenario. This is the assumption. This is not necessarily what will happen, and I'm not telling you what you should do or not do, or foreordain for you what should be. We have to make such assumptions.

Three billion dollars of interest costs would be saved with this package. These estimates are based on political possibilities and current projections at this time. With the kind of current service estimates and economic experience that we have, we find that the reduction job to get the Gramm-Rudman targets could be on the order of $60 to $65 billion, not $30 to $35 billion.

And so a more appropriate dose of deficit reduction would be a program of $50 billion reduction in year 1; $40 billion in year 2; and $38 billion in year 3—a 3-year plan to wipe out the structural budget deficit that is in place.

How could this be done? What kind of program? Twenty-five billion dollars of defense and nondefense spending reductions; $10 to $15 billion of tax increases, and $5 to $10 billion of interest savings from the package would be about right.

The tax increase in such a program should not be on income or profits. A gasoline tax increase would be sufficient and efficient.

A gasoline tax at 10 to 15 cents a gallon is desirable for several reasons, including oil and energy conservation, reducing imports and reducing consumption, increasing savings for revenue enhancement. Gasoline taxes in the United States would still be far below other countries.

This prescription should be accompanied by an explicit understanding or a suggestion that the central bank ease up on monetary policy. Mixing the doses of fiscal and monetary policy by tightening the budget and easing monetary policy appears to me to be the prescription for sustaining the expansion and not accelerating inflation.

In summary, we have reached an enviable position in our business expansion. We are close to full employment and that is a great achievement for our economy.

How we got there at this point is not as relevant as the question of how can we keep a good thing going.

The textbook computer model answer is easy in theory, but not in practice. A tighter budget will restrain the excessive growth of the economy by reducing the excessive deficits at full employment and easier monetary policy can be used to prevent the tighter budget from bringing a downturn in the economy.

A $50 billion for deficit reduction may sound like a lot, but that number is very small in a $4 trillion-plus economy. A $50 billion deficit reduction would slow growth by about 1 percentage point. And, that could be offset by a 1 to 1.5 percentage point reduction in interest rates.

Shifting the mix of policy would create a lower interest rate profile, permitting us to be more capital intensive in our production and helping productivity growth, perhaps doing something to pump up the rather anemic 2.6 percent per annum rate of growth for potential that we are finding. Thank you, Mr. Chairman.

[The prepared statement of Mr. Sinai, together with attachments, follows:]

PREPARED STATEMENT OF ALLEN SINAI*

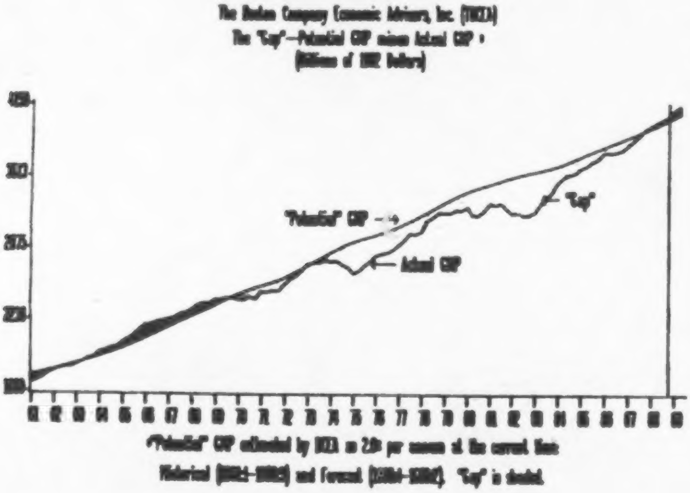
Sustaining Noninflationary Growth at Near Full Employment

For the U.S. economy in 1989 and 1990, the $64 question is how to sustain the long expansion at near full employment without accelerating inflation.

This question has emerged over the last year or so as the key to the future as the economy has moved closer to full employment. For much of this decade, dealing with policies to keep the economy growing without generating higher inflation was not relevant. In the aftermath of the Great Recessions of 1980 and 1981-82, so much slack existed in the U.S. economy and room to grow that issues related to full employment were nowhere on the foreseeable horizon.

But, times have changed. As Chart 1 shows, by one measure, the "gap"--the difference between estimated potential real GNP and actual real GNP--is no more. From a shortfall of over 11% in late 1982, the gap has been eliminated.

Chart 1
The "GAP" is Gone!



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*Chief Economist, The Boston Company; President and CEO, Boston Company Economic Advisors; Adjunct Professor of Economics and Finance, Lemberg Program in International Economics and Finance, Brandeis University.

For the first time since 1972-73 and the late 1960s, actual real GNP exceeds potential, as estimated by The Boston Company Economic Advisors, Inc. (BCEA). Starting early in 1988, slack in the economy ran out according to this measure, with real GNP now about $50 billion above potential. Other measures of full employment also suggest that the economy has or is running out of slack, with the civilian unemployment rate at a 14-year low of 5.3% and capacity utilization for industry running at 84.3%.

Although all three measures of full employment are imprecise and not exact in measuring how tightly against capacity the economy is pushing, there can be no doubt that a "full employment zone" has been reached. In the full employment zone, economic activity and production bump up against capacity limitations in product, labor and financial markets, generating higher inflation, constraining real economic growth, and posing difficulties for the economy on international account and on domestic inflation.

The core ingredients of any downturn have always included capacity limitations, accelerating inflation, and the higher interest rates imposed by the central bank in order to keep inflation below a threshold level of tolerance. Although the U.S. economy shows absolutely no signs of recession, or even a slowdown, at this time and is extremely well-balanced, the presence of these core ingredients signals the possibility of a turning point and the negatives that can go with any economic downturn.

Once the full employment zone has been reached, inflationary pressures build, shortages in labor and product markets begin to crop up, monetary policy necessarily turns tighter, interest rates rise, financial troubles ensue, private sector balance sheets become overextended, and the downturn moves into place. The timing always is uncertain, ranging from only a short period of time to as long as two or three years, but recessions have always followed full employment conditions in the U.S. economy. So far in the postwar period, the achievement of noninflationary growth at near full employment has been elusive.

What is the outlook for the economy during 1989 and 1990? What policies--monetary, fiscal and supply-side--might be followed to sustain the expansion without higher inflation? What, in particular, is necessary on the federal budget and international policy coordination to maintain the expansion?

The BCEA forecast shows continued above-potential growth in the real economy through midyear, accelerating inflation into a 5% to 6% range as a by-product, further necessary restraint by the central bank in the absence of significant progress on reducing federal budget deficits, rising interest rates through summer, then a slowdown, and a mild recession during the first half of 1990. Because the dollar is weaker on such a scenario and U.S. inflation higher than in many other countries, the U.S. is seen as unable to recapture a strong competitive position in the world economy. Relatively slow economic growth, reasonably higher inflation and an unemployment rate well in excess of 6% may characterize the 1990-91 years as a consequence, a subpar performance.

This forecast, which is based on current conditions and best guesses at policies in Washington, does not have to occur. Policies to sustain the expansion at minimum risk to inflation and to enhance the potential growth of the economy could be taken. There is no overwhelming reason why business expansions must end in a downturn, provided that the appropriate policy settings are made in Washington at the appropriate time.

The BCEA Outlook and Key Assumptions

January marked the 74th month of the current expansion, now the second longest in the postwar period next to the record 106-month upturn of 1961 to 1969.

Despite so long an expansion, the economy continues to show up quite well in the here and now.

Real economic growth, after accounting for the effects of last year's drought, rose a little over 3% in the second half of 1988 and showed good momentum coming into the new year. The unemployment rate is near a 14-year low, at 5.3%, with solid growth in employment, both in the industrial and services sectors. Growth is solid, there are no particular excesses or imbalances in the internal mechanisms of the economy, the industrial sector has come on strong, and employment and incomes are rising nicely. Inflation is too high for comfort, but accelerating only gradually. Productivity growth is slowing and unit labor costs rising. And, the internal and external deficits remain far too high, threatening to mortgage the future of the U.S. economy beyond the next decade.

The economy became more well-balanced in 1988, for the most part driven up by a sharp improvement in real net exports, a strong business sector, and supported by good consumer spending. Regionally, the economy also seems quite well-balanced, with previously booming areas such as the Northeast now showing up weaker and previously depressed areas such as the Midwest now showing up stronger. The traditional signs of a slowdown or downturn are not present coming into 1989, suggesting that the business expansion can continue through this year.

Why has the expansion lasted so long?

One reason is the great slack and unemployed resources at the start of the upturn, which created a lot of room for expansion without too much inflation.

Second, budget policy has been stimulative through massive reductions in personal income and corporate profits taxes and strong government spending, helping to propel the economy onward and upward.

Third, since 1982 monetary policy periodically has operated to retard the pace of expansion, postponing the day when the economy might reach full employment, generate unacceptably high inflation, and develop the imbalances that often lead to a recession. A rolling adjustment of sectoral and regional activities, tied to ebbs and flows of foreign trade, especially exports, also helped. Large segments of the U.S. economy, increasingly tied to overseas

Allen Sinai, Chief Economist

U.S. Economic Forecast

January 30, 1989

Forecast of the U.S. Economy and Financial Markets
(Probability of 0.65)

	Quarters						Years			
	1988:2	1988:3	1988:4	1989:1	1989:2	1989:3	1987	1988	1989	1990
Gross National Product-1982 Dollars	3985.2	4009.4	4029.1	4087.6	4119.7	4146.3	3847.0	3995.0	4126.0	4152.8
Annual Rate of Change	3.0	2.5	2.0	5.9	3.2	2.6	3.4	3.8	3.3	0.7
Percent Change Year Ago	4.2	3.7	2.7	3.3	3.4	3.4	5.0	2.7	3.0	1.0
Consumption	2579.0	2603.8	2621.9	2635.6	2653.2	2675.6	2520.9	2591.1	2658.0	2674.6
Annual Rate of Change	3.0	3.9	2.8	2.1	2.7	3.4	2.7	2.8	2.6	0.6
Business Fixed Investment	490.2	495.0	490.4	498.6	508.0	516.7	445.2	487.3	510.6	515.3
Annual Rate of Change	15.0	4.0	-3.7	6.9	7.8	7.0	2.8	9.5	4.8	0.9
Residential Construction	189.6	191.6	197.4	194.3	192.4	191.1	195.2	192.0	191.9	187.7
Inventory Investment	35.3	39.5	29.2	51.2	43.2	32.0	34.4	42.5	38.2	15.7
Net Exports	-92.6	-93.9	-100.7	-97.7	-87.4	-84.5	-128.9	-99.1	-85.4	-71.1
Federal Government	331.6	320.1	332.9	344.5	346.8	349.6	339.0	328.1	348.1	356.4
Annual Rate of Change	4.7	-13.2	17.0	14.7	2.7	3.3	1.7	-3.2	6.1	2.4
State and Local Government	452.2	453.4	458.0	461.1	463.5	465.8	441.2	453.1	464.7	474.2
Annual Rate of Change	3.2	1.1	4.1	2.7	2.1	2.0	3.3	2.7	2.6	2.1
Industrial Production (1977=1.000)	1.360	1.384	1.397	1.411	1.432	1.444	1.298	1.372	1.432	1.453
Annual Rate of Change	4.5	7.1	4.0	4.0	6.0	3.4	3.8	5.7	4.4	1.5
Housing Starts (Mils. Units)	1.481	1.468	1.538	1.525	1.465	1.425	1.634	1.491	1.436	1.535
Auto Sales-Total (Mils. Units)	10.6	10.6	10.5	10.0	10.6	10.2	10.3	10.6	10.2	9.5
Unemployment Rate-Civilian (%)	5.4	5.5	5.3	5.3	5.2	5.3	6.2	5.5	5.3	5.8
Federal Budget Surplus										
Unified (Quarterly Rate, NSA, FY)	0.3	-35.8	-67.6	-55.7	-16.6	-25.5	-149.7	-155.1	-165.4	-176.9
Implicit Price Deflator (%CH)	5.5	4.7	4.7	5.6	5.5	5.6	3.3	3.4	5.3	4.6
CPI- All Urban (%CH)	4.8	4.7	4.3	5.5	5.4	5.9	3.7	4.1	5.2	4.7
PPI-Finished Goods (%CH)	4.1	5.7	2.8	6.0	5.1	5.7	2.1	2.5	5.0	4.6
Hourly Compensation (%CH)	4.2	5.8	5.1	5.3	5.4	5.2	3.8	4.7	5.3	5.2
Trade-Weighted Exchange Rate	0.865	0.909	0.872	0.888	0.872	0.852	0.942	0.880	0.864	0.831
Annual Rate of Change	-4.3	21.7	-15.1	7.4	-7.2	-8.5	-11.1	-6.6	-1.9	-3.7
Merchandise Trade Balance (Bils. $'s)	-133.1	-129.7	-136.2	-135.3	-127.5	-120.8	-171.2	-137.2	-123.3	-101.9
Corporate Profits Aftertax (Bils. $'s)	162.7	169.1	173.8	177.9	180.5	171.9	142.9	163.8	175.3	171.2
Percent Change Year Ago	15.3	13.1	19.3	19.1	10.9	1.7	10.1	14.6	7.0	-2.3
Adjusted Profits Aftertax (Bils. $'s)	183.3	185.2	197.4	199.7	201	191.9	176.6	186.3	195.8	186.2
Percent Change Year Ago	6.2	1.7	9.7	11.3	9.7	3.6	-8.2	5.5	5.1	-4.9
Real Disposable Income (Bils. $'s)	2762.2	2800.4	2832.8	2854.5	2875.0	2890.0	2686.3	2789.4	2877.7	2919.8
Annual Rate of Change	0.0	5.6	4.7	3.1	2.9	2.1	1.7	3.8	3.2	1.5
Personal Saving Rate (%)	3.7	4.2	4.6	5.0	5.1	4.8	3.2	4.3	5.0	5.9
M2 (Bils. $'s)	3003.2	3030.4	3053.3	3101.8	3143.6	3175.3	2897.3	3053.3	3208.9	3341.0
Annual Rate of Change	8.0	3.7	3.1	6.5	5.5	4.1	4.0	5.4	5.1	4.1
Prime Rate (%)	8.78	9.71	10.19	10.67	11.15	11.35	8.21	9.32	11.12	9.51
Federal Funds Rate (%)	7.15	7.98	8.44	9.23	9.52	9.60	6.72	7.56	9.26	7.61
3-Month Treasury Bills (%)	6.22	7.01	7.73	8.43	8.88	8.99	5.78	6.67	8.64	7.03
10-Year Treasury Note (%)	8.89	9.10	8.93	9.15	9.69	9.76	8.38	8.83	9.49	8.38
30-Year Treasury Bond (%)	9.04	9.17	8.97	8.99	9.42	9.54	8.57	8.95	9.35	8.65
New AAA-Equiv. Corporate Bonds (%)	9.90	10.03	9.76	9.71	9.99	10.10	9.41	9.77	9.81	9.40
Bond Buyer Index (%)	7.84	7.74	7.73	7.37	7.58	7.81	7.64	7.74	7.49	7.37
S&P 500 Index of Common Stocks	263.13	266.91	274.98	297.73	302.89	292.42	286.99	265.74	292.01	280.32
Annual Rate of Change	8.3	5.9	12.7	37.4	7.1	-13.1	21.5	-7.4	9.9	-4.0
Earnings Per Share - S&P 500 ($)	6.25	6.38	5.87	6.18	6.38	6.77	17.53	24.05	25.52	25.75
Percent Change Year Ago	98.4	20.2	27.6	11.4	2.1	6.1	21.1	37.2	6.1	0.9
Price-Earnings Ratio - S&P 500	12.1	11.7	11.4	12.1	12.2	11.6	18.4	12.3	11.7	11.0

Forecast Assumptions—U.S. Economy and Financial Markets

Fiscal policy—budget and taxes: Small deficit reductions legislated for fiscal years 1988 and 1989 and weaker economic growth later in 1989 and in 1990 imply that federal budget deficits will keep rising in the absence of further legislation. The deficit was artificially low in FY1987, at $149.7 billion, declining sharply from over $220 billion. The Tax Reform Act of 1986 added about $22 billion in one-time receipts from capital gains taken in 1986. One-time savings on spending, such as loan asset sales, amounted to $15 billion. The FY1988 result was higher, at $155.1 billion.

BCEA estimates the current services deficit (no changes from current law) at $161.1 billion in FY1989 and $178 billion in FY1990. The Congressional Budget Office (CBO) is estimating a $155 billion deficit in 1989 and $141 billion in 1990. In July the Office of Management and Budget (OMB) estimated the current services deficit at $132.5 billion in 1989 and $110.9 billion in 1990. Recently, the OMB revised the FY1990 deficit forecast to $132 billion.

Since last July, new legislation added $5.9 billion to the current services estimates in each year. The OMB July estimate did not reflect an estimated $3.9 billion for the Disaster Assistance Act of 1988, passed in August to aid drought-stricken farmers. Legislation since August added a further $2 billion to the FY1989 deficit. The passage of the Omnibus Trade and Competitiveness Act of 1988 added a modest $0.4 billion. The Hunger Prevention Act added $0.3 billion and the Drug Enforcement Act increased the deficit by $0.5 billion.

BCEA's higher current services budget deficit estimates reflect different assumptions relating to economic growth, higher inflation and higher interest rates, as well as higher projections on agriculture and military outlays, than either the OMB or CBO for 1989 and 1990.

Included in the current services estimates are the effects of the Omnibus Reconciliation Act of 1987, which sought to reduce the deficit by $33.6 billion in FY1988 and $41.9 billion in FY1989—with future legislation needed to ensure continued deficit reduction. Of the projected improvement, roughly $23 billion has materialized, $9 billion in new revenues and $14 billion in spending restrictions. "Hard" savings for FY1989 are projected at $36 billion—$14 billion from spending and $22 billion in revenue enhancement. FY1990 and beyond will require further actions to meet the Gramm-Rudman-Hollings (GRH) targets.

The FY1989 deficit estimated by the OMB in October, as measured by the arcane language of GRH, was $145.6 billion—$0.4 billion below the level for a sequester order. But, just three months later, the Reagan budget submission showed a $161.5 billion FY1989 deficit, in part from thrift bailout costs. The GRH target for FY1990 is $100 billion, with a sequester ordered if the OMB estimate on October 15, 1989 exceeds $110 billion. Even then, Congress has the power to enact new revenues or to cut outlays to reverse the sequester. Or, Congress and the Administration could act to alter or delay GRH again—the BCEA assumption on the action to be taken (late summer).

For FY1989, the BCEA forecast is an increase in the unified budget deficit to $165.4 billion as slower economic growth lessens tax receipts and higher inflation boosts outlays. The Reagan Administration forecast is $161.5 billion. The CBO expects the same deficit in FY1989 as in FY1988, at $155 billion. The BCEA estimate for FY1990 is $176.9 billion. About $9 billion a year for thrift bailout is estimated.

The growing Social Security surplus is included in the unified budget, at $38.8 billion in FY1988. For fiscal years 1989 and 1990, the surpluses are estimated by BCEA at $53.7 billion and $65.4 billion. Thus, without the surplus, the on-budget deficit was $193.9 billion in FY1988 compared with $169.2 billion in FY1987. The deficit without the surplus is forecast at be $219.1 billion in FY1989 and $242.3 billion in FY1990.

The Reagan budget submitted January 9 projected deficits meeting GRH targets without new taxes, through some reductions in defense spending (efficiency), large reductions in nondefense, and more user fees. In February, the Bush Administration is assumed to propose some modifications but no new taxes, using the "Flexible Freeze" as a guideline. More cuts are offered up on defense; big reductions requested on non-defense; some tax credits; and a reduced capital gains tax. Congress and the Administrtion negotiate until late summer, when GRH catches up with the process. With the GRH sequester too severe (about $65 billion, BCEA), a modest reduction is finally agreed upon—$30 billion to $35 billion on paper and $20 billion to $25 billion in bona fide savings, including a modest rise in gasoline taxes.

Monetary policy: Over time, the choices for the Federal Reserve become tougher with the economy in a full-employment zone and inflation rates higher than targeted. After holding early in the year, more tightening becomes necessary in the first half of 1989. The rest-of-the-world cannot help through easier monetary policy, since so many economies are performing well and setting tough targets on inflation. Overseas, short-term interest rates are firm with upward pressure off strong economies and early year weakness in the currencies.

Oil: Crude oil prices fluctuate widely between $14 and $19 a barrel for North Sea Brent and West Texas Intermediate spot crudes and reach $16 to $17 a barrel for refiners' acquisition costs. OPEC's overproduction is reduced during the winter, both from the November agreement on production quotas by OPEC members and stronger demand—in part seasonal, but also from strong economies. Spot oil price volatility persists in 1989, with the next test for OPEC in April. By yearend, oil is at $20 a barrel.

Commodity prices: Modest increases from the inflationary effects of economic strength in the U.S. and overseas. The big slack previously created by ample supplies of commodities is essentially gone, especially for industrial commodities; but, neither are there short supplies.

Wages, unit labor costs, and labor negotiations: Wages pick up because of growing tightness in labor markets, first in services and then in manufacturing. In 1989, wage catch-up starts to show in bargaining, especially in manufacturing where economic activity remains strong. Productivity growth rose nicely in 1988 with sharply higher industrial output, but is likely to fade in 1989. Unit labor costs rose by nearly 3-1/2% in 1988 and are up by about 4% to 5% in 1989. Labor negotiations did not produce big wage compensation increases in 1988, focusing instead on job security and benefits. 1989 will begin a major testing time on wage negotiations.

Third World debt and bank problems: Pending crises have been postponed for another year for the three largest Latin American debtors. Brazil is now current on interest payments after a new $5.2 billion loan from banks. Mexico's problems have been eased by a $3.5 billion "bridge" loan from the U.S. and higher oil prices help in 1989. Argentina received a total of $1.75 billion in loans from the World Bank and BIS countries, and negotiations for additional funds are underway with the IMF. Nevertheless, the Latin American economies are far from stable, and until more permanent solutions are found their problems will continue to be a potential source of fragility in the world economy.

International: 1988 was one of the better years for European and Canadian growth and excellent for Southeast Asian countries. In 1989, good growth should continue but some problems for the world economy will crop up. Inflation will be higher and trending up, with higher oil prices contributing. Trade imbalances remained largely uncorrected in 1988, building pressure for more action in 1989. A G-7 meeting should take place early in 1989, with policies on coordination initially following the same tack as previously. However, if the U.S. does not move on the budget deficit, the G-7 Group will become more contentious.

The dollar and trade legislation: Downward drift for the dollar, on average, over the longer-run, based on the fundamentals of still high trade and budget deficits, growing debt, relatively high U.S. inflation and lots of competition for investment funds worldwide. Further progress on the trade deficit from the lows of summer is difficult. Early year strength in the dollar gives way as the trade deficit stays high. Rotating, coordinated, and sometimes heavy intervention periodically occurs and minor interest rate adjustments are made as the dollar drifts in zones—near term, 1.80 to 1.90 deutschemarks, 125 to 135 yen, 6 to 6.50 French francs, and $1.75 to $1.90 on the pound sterling; then lower at 1.70 to 1.80 deutschemarks, 115 to 125 yen, 5.75 to 6 French francs, and over $1.90 on the pound.

The mildly protectionist trade legislation of 1988 settles trade issues for awhile, with GATT and implementation of the Trade Act coming on to center stage.

economic activity, actually were in recession during 1985-86--not enough to pull the overall economy down but enough to open up and maintain room for more expansion.

Fourth, inflation rates declined, on average, between 1982 and 1987 and with them, interest rates. Lower inflation and lower interest rates, along with the reductions in personal income taxes, helped to sustain consumer spending at a strong pace.

Fifth, other economies in the rest-of-the-world have kept growing, lately even stronger, helping U.S. exports leap higher in 1987 and 1988.

Now, in 1989, thanks to the long and strong expansion, the slack that permitted the economy to keep growing and inflation rates to stay low has given way to a nearly fully employed economy with gradually rising inflation. At 4-1/2% to 5%, the inflation in prices and wages accelerated by one-half to three-quarters of a percentage point in 1988. Capacity limitations, too high inflation, and rising interest rates are the core ingredients of economic slowdowns or recessions.

For 1989, the issue is whether a "soft-landing" can be achieved for the economy--economic growth at the rate of increase in potential supply--thus sustaining the expansion even longer without too much inflation and at near full employment. To sustain the long expansion will require slower, rather than faster, growth; a lessening of inflation; and the creation of more capacity to permit continuing increases in production and employment.

Mindful of this, the Federal Reserve has twisted the dials on monetary policy--used to enhance and sustain the expansion since 1982--more toward restraint than stimulus. In 1988, the central bank raised short-term interest rates by nearly 2-1/2 percentage points, leaning against inflation in excess of 4%, and attempting to guide the economy to a soft-landing. This represented a sea change from earlier years, when monetary policy was used to stimulate the economy without fear of too much inflation.

For the Federal Reserve, last year's strategy was to use modest doses of restriction to gently nudge economic growth and inflation lower. Although the reported figures for real GNP were in the central bank target range of 2% to 2-1/2% for the second half, ex-drought, growth was over 3%. Since the drought calculations are arbitrarily made by the Department of Commerce and do not correspond to actual economic activity, the soft-landing strategy has not yet born fruit.

The role of the federal budget was one of stimulus last year, with increases in the structural budget deficit and unified budget deficit. The large deficits added to the strong business sector impulse on the economy. The Omnibus Reconciliation Act of 1987, a two-year plan, essentially put off further actions to reduce the federal budget deficit until this year.

For 1989, the strong momentum of the economy at yearend and good balance should be sustained through at least the first half of the year. A 5-1/2% to 6% increase in real GNP is forecast for the first quarter (about 3-1/2% ex-drought) and 3% to 3-1/2% in the second quarter. However, growth in excess of 3% and the higher oil prices of late 1988 likely will force inflation into a 5% to 6% range. This, in turn, can be expected to push the Federal Reserve into a tighter monetary policy stance, with short-term interest rates rising by one-half to one percentage point into the third quarter and bond yields up one-half to three-quarter percentage points.

Whether this pattern of inflation and interest rates results in a soft-landing for the economy, has minimal effect, or ends up in an overshooting to recession is the big question for 1989 and 1990. The BCEA forecast shows the economy sliding late in 1989 and a mild downturn during the first half of 1990 as a consequence.

The task of engineering a soft landing is very delicate and runs two risks. One is the possibility of too little restraint, too strong growth, and too much inflation. The other is too much restraint and the risk of recession. The balancing act being tried by the Federal Reserve will be made even more difficult in 1989 because of large deficits. These produce stimulus (large budget deficits) or weakness (large trade deficits) and are hard to calibrate and offset.

Budget prospects indicate some rapprochement between the Bush Administration and Congress on budget deficit reduction, a key to sustaining noninflationary economic growth and certainly of help in limiting any tightening of monetary policy by the Federal Reserve. But, budget policy cannot do much to affect the 1989 economy, since Congress and the Administration are focussing on fiscal year 1990.

The BCEA forecast estimates considerably higher deficits than the Administration and the Congress or even CBO, $165.4 billion in FY1989 and $176.9 billion in FY1990. The estimates reflect higher Current Services budget deficit estimates--less help on the budget deficit from economic growth and interest rates, higher defense and agriculture spending, more spending on the thrift bailout problem, and a plug factor for nuclear waste cleanup and infrastructure outlays.

The possibility for an unforeseen worsening in the deficit seems greater than the reverse. In the three months ending December 1988, the spending on thrift problems already had reached $8 billion, almost a full year's allotment in the Reagan budget.

Private sector estimates of the federal budget deficit for FY1990 probably will range from $140 billion to $165 billion, but are very uncertain given the extent of the bailout required for the thrifts and other budgetary matters over the next few years.

The overall results for the economy in 1989 show up reasonably well in the BCEA forecast--3.3% real growth for 1989 over 1988, a 3% fourth quarter-to-fourth quarter growth rate; another strong year for the industrial economy with exports up 10% and capital spending rising near 6% in inflation-adjusted terms; supportive consumer spending to the tune of 2-1/2% to 3% in real terms; cautiousness on inventories; and soft residential construction. But, the problem for the economy arises in significantly higher inflation and the imbalance on policies, with only the central bank leaning against the inflation.

Allen Sinai, Chief Economist

World Outlook Summary

January 30,1989

(Probability of 0.65)

	Real Growth* (Percent Change)				Inflation-Consumer Prices** (Percent Change)				Unemployment Rate (Percent)				Current Account Balance*** (Billions of U.S. Dollars)			
	1986	1987	1988	1989	1986	1987	1988	1989	1986	1987	1988	1989	1986	1987	1988	1989
United States	2.8	3.4	3.8	3.3	1.9	3.7	4.[illegible]	5.2	7.0	6.2	5.5	5.3	[illegible]	-154.0	-136.7	-126.4
Canada	3.2	4.0	4.2	3.5	4.2	4.4	4.0	4.5	9.6	8.9	7.8	7.7	-7.[illegible]	-8.9	-6.7	[illegible]
Europe	2.5	2.6	2.9	2.7	2.4	2.7	3.1	3.7	10.5	10.4	10.0	9.6	51.3	42.9	28.9	33.6
France	2.2	2.4	3.1	3.0	2.5	3.3	2.7	3.5	10.7	11.2	10.2	9.8	3.0	-4.1	-1.5	-3.5
Germany	2.3	1.8	3.5	3.0	-0.2	0.3	1.1	2.0	8.9	8.9	8.8	8.4	39.1	[illegible]	46.5	45.2
Italy	2.9	3.1	3.8	3.3	6.1	4.6	5.0	5.4	13.7	14.2	16.1	15.5	2.5	-1.0	0.5	1.2
Switzerland	2.7	2.4	2.7	2.6	0.8	1.4	1.9	2.4	0.8	0.8	0.7	0.6	6.8	7.2	6.4	6.5
United Kingdom	2.8	3.6	1.4	1.7	3.4	4.1	4.9	5.4	11.8	10.5	8.5	8.1	-0.1	-4.1	-25.0	-15.8
Compromise GDP†	3.0	4.2	3.5	3.0	—	—	—	—	—	—	—	—	—	—	—	—
Far East	3.5	5.1	5.7	4.6	1.5	1.1	1.8	2.5	—	—	—	—	97.6	[illegible]	88.5	64.7
Japan	2.5	4.2	5.7	4.5	0.6	0.1	0.7	1.6	2.8	2.8	2.5	2.3	85.8	86.7	76.7	61.5
Korea	12.3	12.0	10.1	8.0	2.3	3.0	7.2	5.9	—	—	—	—	4.6	9.9	14.0	7.9
Taiwan	11.7	11.9	5.8	5.1	0.7	0.0	1.2	1.8	—	—	—	—	16.2	18.1	[illegible]	8.2
Hong Kong	10.4	13.6	6.5	4.3	2.8	5.5	7.4	7.7	—	—	—	—	0.1	0.0	-1.[illegible]	0.2
Singapore	1.8	8.8	10.9	6.5	-1.4	0.5	1.6	2.5	—	—	—	—	0.5	0.5	-2.0	-3.2
Australia	2.2	4.0	2.8	3.1	9.1	8.5	7.2	7.4	8.1	8.1	7.3	6.7	-9.6	-8.6	-11.2	-9.9
Latin America	3.5	2.3	1.1	2.0	109.4	238.7	470.9	187.0	—	—	—	—	-11.1	-3.3	-7.7	-2.5
Argentina	6.5	2.6	-1.1	1.7	81.9	174.8	387.4	250.0	—	—	—	—	-2.9	-3.4	-3.2	-2.6
Brazil	8.2	3.5	0.2	1.5	142.3	366.4	933.7	320.0	—	—	—	—	-4.5	-3.7	2.1	1.8
Mexico	-3.8	1.1	2.0	2.5	105.7	159.2	51.7	47.5	—	—	—	—	-1.7	3.9	-2.3	1.2
Venezuela	5.1	1.3	4.2	3.0	12.7	40.3	35.5	25.8	—	—	—	—	-2.0	-0.1	-4.3	-3.0
World	2.9	3.5	3.8	3.4	8.4	17.0	31.2	15.1	—	—	—	—	-8.6	-15.8	-36.7	-39.5
OECD	2.7	3.4	3.9	3.4	2.1	3.0	3.3	4.2	7.3	6.9	6.3	6.0	-18.9	-41.0	-49.0	-50.0
EEC	2.5	2.6	3.0	2.8	2.5	2.8	3.1	3.8	10.9	10.9	10.4	10.0	44.5	35.7	22.5	27.1

* Expenditure Real GNP or GDP, depending on the country

† Average of Expenditure, Production and Income Measures

** Annual average, except for Latin American countries which are percent change, December-over-December

*** Hong Kong, trade balance

Forecast Assumptions—Rest-of-the-World

France: Higher economic growth than expected will bring in more tax revenues than planned. As a result, the government's budget plan for 1989 includes an increase in government expenditure, as well as a Fr 24 billion tax cut—mainly in lower value added taxes and in lower corporate taxes for reinvested income, but with a new tax on the 100,000 wealthiest individuals. In addition, the government expects to meet the targeted budget deficit of Fr 100 billion for 1989—down from an estimated Fr 115 billion in 1988. The new Socialist government has virtually abandoned the privatization program enacted by the Conservatives. Maintaining a low inflation rate and keeping the value of the franc steady also are stated government objectives. Monetary policy continues to focus on interest rate management, a policy started in 1987 after many years of direct credit and foreign capital controls. The franc is weak against the dollar early in the year, strong later, trading between Fr 6.00 and Fr 6.50, then 5.75 to 6.25.

Germany: For 1988, the government deficit is expected to have widened to DM 35.3 billion from 28 billion in 1987, with almost all of the widening accounted for by a sharp DM 7 billion decline in Bundesbank profits. Fiscal policy is expected to tighten in 1989, with lower subsidies, increases in indirect taxes, and the introduction of the interest withholding tax ahead of time. Growth in the monetary aggregate M3 exceeded the 3% to 6% target in all of 1988, but monetary policy was tighter by yearend. For 1989 the target is "about" 5%. Good economic growth, inflation concerns and the policy goal of a strong deutschmark should keep interest rates firm to up. The deutschemark should maintain its solid position against the EMS currencies and the dollar, ranging from DM 1.80 to DM 1.90 early, then DM 1.70 to DM 180 later.

Italy: Italy's coalition government has set a five-year plan designed to cut the budget deficit through higher taxes and lower spending. The budget deficit, Italy's main economic problem, rose to Lit 113.7 trillion in 1987 from Lit 109.9 trillion in 1986. Current estimates place the 1988 deficit at Lit 122 trillion. The budget for 1989 aims to reduce the shortfall to Lit 117.4 billion. Recent curtailment of the practice of secret balloting in the legislature may make the attainment of this target more likely. The exchange rate should fluctuate between Lit 1250 and Lit 1350 against the dollar, while slowly sliding against the deutschemark.

United Kingdom: The strong U.K. economy and sales of public assets have moved the budget into surplus even with a £4 billion tax cut in 1988/89 that simplified the tax structure. The 1988 tax cut was permitted by a £7 billion budget surplus in the 1987/88 fiscal year, despite personal and corporate tax cuts that year. The official forecast for the 1988/89 surplus has been raised to £10 billion from £3 billion. A similar forecast for 1989/90 has raised the possibility of more tax cuts in the March budget, though the Bank of England has come out in opposition. Two problems arise from the strong U.K. economic performance. A high marginal propensity to import is causing the current account balance to deteriorate rapidly while strong consumer spending, declining unemployment, and rising wages point to higher inflation. Monetary policy will stay tight, defending the currency and standing against 6% inflation. After repeated increases of interest rates in 1988, the economy shows some slowing in !989, but the current account deficit continues to be threateningly high.

Japan: Japanese industry has adjusted to the higher value of the yen and the economy is responding to the domestic sector—especially consumer and capital spending. The budget for fiscal 1988/89 included a 4.8% increase in expenditures, the largest in six years. A new tax reform program has now been enacted, to be implemented starting April 1, 1989. Key features include a ¥1.3 trillion cut in personal income taxes and a 3% value added tax. In 1987, tax reform included ¥1.54 trillion in tax cuts and abolition of the *maruyu* system, under which interest income from savings of less than ¥3 million was tax exempt. The Recruit Cosmos scandal has resulted in a major shake-up of the Cabinet, though the position of Prime Minister Takeshita appears secure. Monetary growth is quite high and, with the economy strong, the ongoing question for the BOJ is whether to tighten. Low inflation forestalled a snugging in late 1988, but is less likely to do so in 1989, especially with import oil prices up. The value of the yen should range between ¥125 and ¥135 to the dollar near term, with periodic BOJ intervention, appreciating to between ¥115 and ¥125 by midyear and ¥110 at yearend.

Canada: The budget deficit for FY87/88 was C$28 billion, about C$1.3 billion less than expected and C$2.6 billion lower than in FY86/87. Higher tax revenues from strong economic growth accounted for the lower deficit. Although the first stage of a proposed tax reform includes a lowering of personal tax rates, its method of implementation actually results in a fiscal tightening in 1988 and 1989. Monetary policy is committed to restraining inflation, with the yield curve inverted. The reelection of Prime Minister Mulroney and the ruling Conservative Party continues to help the Canadian dollar and has set the U.S.-Canada free-trade agreement in place.

East Asia: The stellar growth of 1986-88 slows somewhat in 1989, as exports to the U.S. lessen and imports increase. Taiwan saw foreign demand slacken in 1988, but still grew nicely. South Korea should have another strong year as new industries open up export opportunities—especially in cars and electronics—and export-led growth continues. Hong Kong should benefit from China's improved import position and Pacific Basin economic strength. Singapore's recovery will hold as trade and commerce increase in that region.

Latin America: Increased cooperation of major debtor nations with lending banks will not outweigh a fundamentally negative situation. Rampant inflation, in triple or high double-digits, along with high government spending, remain the symptoms of severe economic imbalances in all major Latin economies. Debt-for-equity swaps have become a more important angle in debt management, and some form of securitization of LDC debt will likely be implemented. Commercial banks will have to keep increasing reserves against Latin American loans. All of the four major Latin American countries now face economic difficulties, partly due to failed economic packages and partly due to lack of capital from abroad.

Responding to the 934% inflation rate at yearend, the new Brazilian Congress has recently approved measures to deal with the problem. These include a price freeze, currency devaluation and the deindexation of the economy. Nevertheless, a proposed cut of up to 90,000 government employees is unlikely to be carried through, leaving little room for badly needed cuts in government spending.

Argentina's negotiations with the IMF on a new economic program and $1.2 billion in loans have progressed slowly. Nevertheless, the World Bank went ahead with a new loan to Argentina totalling $1.25 billion, while the U.S. and other developed countries have put together a $500 million "bridge loan."

Mexico's President Carlos Salinas De Gortari, has indicated that he would likely seek debt rescheduling and restructuring following the G-7 meeting.

Venezuela's new President, Mr. Carlos Andres Perez, is to announce a new economic package designed to qualify the country for IMF and World Bank loans. Venezuela declared a moratorium on principal debt payments to international banks effective in January 1989.

The G-7 will concentrate on Latin American debt as a high priority in 1989.

There are a number of key assumptions in the forecast--

1) crude oil prices stay firm at $16 to $18 a barrel and then $21 a barrel late in 1989.
2) the U.S. trade deficit improves only a little, by about $14 billion instead of the $34 billion last year. Less growth in exports and still high imports prevent a significant further improvement in the trade deficit and later this year send the dollar lower.
3) the central bank sticks to its guns, aiming at a 2-1/2% to 2-3/4% growth rate for the economy, in contrast to the expectations of 3%+ of the Administration.
4) the budget process proves to be long and tortuous, with the Administration sticking to a modified version of the Reagan approach--strong defense, much less spending in nondefense, and no new income taxes.
5) the rest-of-the-world economies grow strongly and exhibit rising inflation rates. Higher interest rates are required, hurting the dollar and pushing up U.S. interest rates. A boomy world economy adds to inflation.

These assumptions do not have to be fulfilled; if not, the pattern that is forecasted would not be approximated.

Policy Twist to Sustain the Expansion--How To Do It?

In textbooks and in computer models of the U.S. economy, it is relatively easy to sustain the economy at near full employment without too much inflation through the appropriate mix of monetary and fiscal policy.

In the old textbook version of how to sustain growth in a nearly fully employed economy, the answer is less federal spending, higher taxes or higher interest rates, alone or in some combination. Such restriction, even if doled out in small doses, would restrain the economy and lower inflation, although with lags. However, a danger in this approach is that the restraint can be overdone, engendering a recession and all of the risks that go with it in an economy that is so fragile as is the case for the U.S. this time around.

The newer textbooks would use both fiscal and monetary policy in combination, twisting the mix of policy toward a tighter budget and easier monetary policy.

Here, reduced growth in spending and/or higher taxes would be used to restrain the economy relative to its capacity and an easier monetary policy applied to support the economy and to prevent any downturn.

This twist in the policy mix would produce a lower profile of interest rates, probably lower the dollar, stimulate the U.S. industrial sector, raise capital spending and the capital intensity of production, and should enhance the lagging U.S. productivity growth.

A supply-side twist of tax credits or subsidies to increase the productivity of labor and enhance education could be used to pump up the potential growth rate of the economy, now lagging at 2.6% per annum--behind both the historical U.S. trend and that of other major economic powers.

Some targeting and guidance of resources into areas where the U.S. might be more competitive also would be well-advised. A lower profile of interest rates itself could be expected to help increase productivity growth and potential supply.

Although easy in theory and possible at the right time in the right mix in computer models of the U.S. economy, twisting the policy mix in this way, in the right amounts, the right proportions, and with the right lags is extraordinarily difficult in practice.

The biggest impediment lies in the federal budget deficit--its prospects and the clashing of political priorities over the years which has prevented faster progress on reducing the deficit.

Budget Deficit Prospects and Prescriptions

The key to sustaining the expansion lies in a tighter budget. Actions to lower the budget deficit at full employment would serve to slow the economy, reduce imports, and weaken the spending of the public and private sectors. Lessened inflationary pressure would be welcomed. With a tighter budget deficit, the central bank could then act as the fulcrum to prevent the possibility of recession. Slower economic growth and lower interest rates would tend to weaken the dollar, helping U.S. exports. An improved trade deficit would be a plus for the dollar over the longer-run. Lower expected U.S. inflation off a tighter budget also would help the dollar. Improved confidence in the ability of the United States to handle its budget affairs would help improve the dollar. Financial markets would welcome a substantial bona fide reduction in the budget deficit, in turn, with rallies helping to prevent a recession from developing.

At a time when the economy is close to full employment, excessive federal budget deficits are a double-barreled problem.

First, large structural budget deficits at full employment stimulate an economy along with the private sector, tending to create a demand-pull acceleration of inflation. Large budget deficits when the economy has great slack are a plus, stimulating growth, production and employment without an accelerating inflation.

With the gap between potential and actual output having been eliminated, the large, federal budget deficits are inflationary at this time, crowding-out private sector spending if the central bank raises interest rates to limit inflation and generating too much demand if the central bank is permissive.

A second problem is the debt that accumulates with continuing federal budget deficits and the interest charges and the burden of interest costs that arises as a result. If, at the same time, trade deficits and an associated international indebtedness accompany the budget deficits and debt, the ensuing large supply of dollars threatens the dollar and tends to drive the U.S. currency lower. A lower dollar can add to inflation, especially when the economy is near full employment.

BCEA projections show a unified budget deficit of $165.4 billion in FY1989, 3.2% of GNP and an even higher $176.9 billion in FY1990, still at 3.2% of GNP. These figures would be even greater except for the $53.7 billion Social Security surplus in FY1990 and $65.4 billion surplus in FY1990. Without these surpluses, the deficits would be $219 billion and $239.3 billion, respectively, 4.2% and 4.4% of GNP in each of the two fiscal years.

The Current Services budget deficit estimates are $165.4 billion in FY1989 and $193.5 billion in FY1990. The much higher current services deficit than CBO and OMB results from lower real GNP growth in 1990 (1% fourth quarter-to-fourth quarter); higher interest rates than are estimated by the OMB or CBO, 7% on the 91-day Treasury bill rate and 8.4% on the 10-year Treasury note rate in 1990; about an $85 billion bailout for thrifts over the next five years frontloaded in the next two fiscal years; and outlays for nuclear waste cleanup, infrastructure, and others totaling $5 billion to $10 billion a year.

The combination of federal budget and trade deficits, the associated debt, and debt service charges is without precedent in U.S. economic history. Even scaling for GNP and accounting for measurement problems, total debt--government and international--will keep rising relative to GNP through the next five years. Debt service alone will comprise as much of GNP in 1990 as the federal budget deficit itself used to do in a bad year.

The assumption in the BCEA forecast is that Congress and the Administration reach agreement on $30 billion to $35 billion of deficit reductions for FY1990 later this summer or early fall, with about $25 billion bona fide, i.e., real.

The assumed program is an $8 billion reduction in defense spending, essentially a reduction of the growth in defense spending at or a little below the rate of inflation; $12 billion reductions in nondefense spending, especially in medical care and government services; and a $10 billion gasoline tax increase. Some $3 billion of interest costs would be saved with this package.

This estimate is based on the political possibilities and the current projections for the current services deficits of the OMB and CBO. The figure is doable, but the BCEA assumption is that the actual deficits will overwhelm the Congress, depending on the state of the economy, interest rates, and fiscal needs.

With the kind of current services and unified budget deficits estimated by BCEA, it is not expected that Congress would cut the deficit by $60 billion to $65 billion. Gramm-Rudman-Hollings (GRH) would have to be altered yet once again.

A more appropriate dose of deficit reduction would be a $50 billion-$40 billion-$30 billion 3-year plan to wipe out the structural budget deficit that is in place.

The first year program would require $25 billion of defense and nondefense spending reductions, some $10 billion to $15 billion of tax increases, and $5 billion to $10 billion of interest savings.

A tax increase in such a program need not be income or profits taxes; instead, a gasoline tax and excise tax increases would be sufficient and efficient. A gasoline tax hike of $0.10 to $0.15 is desirable on many grounds, including oil and energy conservation, reducing imports, reducing consumption and increasing savings, and for revenue enhancement. Gasoline taxes in the United States still would be far below those in most other countries.

For defense, reducing defense spending to one percentage point below the rate of inflation, limiting SDI funding, and ending some personal weapon systems could produce $10 billion to $12 billion of savings. Nondefense spending reductions will prove more difficult, but savings in health care costs, user fees, and limiting social security benefits to high income individuals is one possibility.

This prescription for reducing the budget deficit should be accompanied by an explicit understanding or agreement with the central bank to ease up on monetary policy if the dose of fiscal restraint slows the economy too much. Less growth reduces tax receipts, and can worsen the deficit, offsetting some of the original budget tightening. Though not ever done except implicitly in the late 1960s, an offsetting easing of monetary policy in return for deficit reduction would be appropriate in a new era of policy coordination, here and abroad.

Mixing the doses of fiscal and monetary policy by tightening the budget and easing monetary policy appears to be not only the textbook prescription, but also the one with the best shot of working in practice to sustain the expansion at near full employment without driving inflation higher.

Dollar and Policy Coordination

Price-fixing in financial markets cannot work indefinitely. The stability in the dollar from G-7 intervention and interest rate changes is hampering the correction of trade imbalances.

Ultimately, propping the dollar above the levels that reduce imports and raise exports results in too high trade deficits and subsequently a lower dollar. The G-7 countries should permit market forces to let the dollar settle, except where unusual circumstances produce a counterproductive result.

Such is the situation now as higher oil prices drive the dollar up, interfering with progress on the U.S. trade deficit. Preventing equilibrating adjustment mechanisms from working in markets prevents equilibration and can set up other undesirable spillover effects. Fixing prices, wages, interest rates and currency levels eventually lead to conditions that can undo the targeting.

An appropriate policy for exchange rates would be to permit more flexibility than the G-7 Louvre Agreement, especially given the sticky trade imbalances still in place around the world. Markets can adjust to wider fluctuations in currency exchange rates than have been permitted since February 1987, given the relatively minor shifts in budget, monetary and trade policies in the G-7 countries. Larger adjustments in domestic macroeconomic policies should be sought if the goal is to stabilize the currencies.

THE BOSTON COMPANY
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Allen Sinai, Chief Economist

Economic Advisors, Inc.
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The "Full Employment" Zone, Inflation, and Economic Activity

by Allen Sinai

After five-and-a-half years of sustained economic expansion under conditions of great slack and excess capacity, the U.S. economy finally has reached a zone of full employment. Too much slack is not now a major problem. Indeed, a lack of slack, more nearly a boom than too little growth, and a developing episode of demand-pull inflation are emerging as a major concern.

Disappearing slack and diminishing excess capacity show up in several ways. In the labor market, the civilian unemployment rate is down to 5.6%; one year ago it was 6.3%. The unemployment rate peaked at 10.7% in November 1982. Capacity utilization in U.S. industry has risen to 82.7%; one year ago it was 79.6%. The low for capacity utilization was 69.5% in December 1982. Large increases occurred in the boom years of 1983 and 1984, with fluctuations in the vicinity of 80% until the middle of last year.

The full employment unemployment rate or so-called "natural unemployment" rate generally has been thought to be 6%. The notion of the natural rate is the unemployment rate where inflation begins to accelerate. Accelerating inflation in current wages and prices most often reflects too much demand relative to supply, i.e., "full employment." Full employment in this sense does not mean all workers actually are being employed—just that inflation is picking up as a reflection of tight labor markets and tighter product markets. Full employment in this sense is an economic concept, not a social one.

Most recently, there has been some thought that the natural rate might be as low as 5% because of slower growth in the labor force, changing demographics, fewer impacts on wages from unions, and a more competitive world economic environment. Whether full employment is at a 6% or 5% level for the unemployment rate, the current 5.6% rate suggests that the economy must be somewhere in a zone of full employment for labor.

Regionally, 22 states show unemployment rates of 5% or less, and 31 states are exhibiting unemployment rates of 6% or below. One year ago, 21 states had unemployment rates below 5%, and 25 were below 6%. Tight labor markets appear in many of these regions, with help wanted signs widespread and wage compensation picking up.

The product markets also are showing a growing lack of slack. A boom in exports over the past year, a surge of activity in U.S. manufacturing, and substantial reductions in capacity now have pushed some U.S. manufacturing industries to levels of activity at or above the last peak operating rates registered in 1978 to 1980. These include Paper and Paper Products, 95.4%; Textiles, 90.6%; Chemicals and Allied Products, 84.9%; Aerospace and Miscellaneous Transportation Equipment, 87.5%; Rubber and Plastics, 88.5%; and Other Durable Goods

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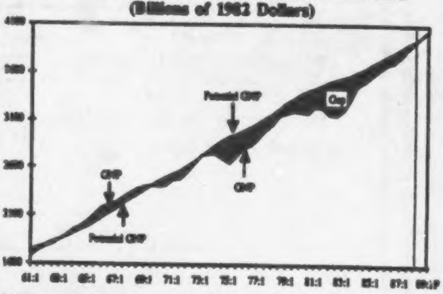
* *Based on an article to appear in the Japan Economic Journal.*

(such as Jewelry, Toys and Games, and Sporting Goods), 82.5%. These industries represent approximately one-third of U.S. manufacturing, thus do not indicate a complete full employment situation for industry, but do suggest an emerging full employment zone for capacity.

Finally, perhaps the most relevant measure for the slack in the economy, the "gap," or the relation of the actual level of economic activity to potential output, has essentially been eliminated.

As Chart 1 shows, actual real GNP is now quite close to potential, after nearly eight years of a large shortfall.

Chart 1
The "Gap"—Potential GNP minus Actual GNP*
(Billions of 1982 Dollars)



* *Potential GNP estimated by BCEA at 2.4% per annum at the current time.*

From a huge gap of 10.8% in late 1982, slack has been steadily and gradually squeezed out of the economy, culminating in the current, estimated small $17.8 billion, or 0.4%, gap in percentage terms between potential and actual employment.

The excess slack in the economy thus essentially has been wiped out, thanks to the long sustained expansion and recent acceleration of growth, but also from a much slower pace of growth in potential output, estimated by Boston Company Economic Advisors (BCEA) at only 2.4% per annum. The long-run trend for the U.S. economy typically had been estimated at 3% growth per year.

Why has the economy reached near full employment?

Reaching the zone of full employment is a result of the long economic expansion, stimulative economic policies, a revival in U.S. exports and industry over the past year-and-a-half, diminishing labor force growth, less growth in productive capital stock, and a smaller pace of productivity growth in the growing services side of the U.S. economy.

Continuing fiscal stimulus from large federal budget deficits is one reason for the sustained expansion. U.S. taxes have been reduced by over $1 trillion in the 1980s compared with what would have occurred under prior law. Starting in 1985, substantial declines in the dollar have occurred, making U.S. exports a bargain in the world economy and helping to revive the U.S. industrial sector. Finally, slower growth in the potential output of the economy than for most postwar years has permitted the "gap" to grow smaller.

Full employment eases one problem of public policy that has been in place for many years—the problem of slack, unemployment, and the lost economic activity that stemmed from the weak economy of the early 1980s. The reaching of the full employment zone thus is desirable and satisfies a major goal of the Reagan Administration.

But, with the reaching of full employment can come yet another problem, rising inflation. Generally, in the postwar period, the disappearance of the gap has been associated with high and rising prices. The U.S. economy typically has been unable to traverse the full employment zone without an unwanted and unacceptable inflation, excesses in the economy and financial markets, eventually a need for substantially tighter monetary policy, and then a recession. Of the eight postwar economic recessions, six have been preceded by periods of boom and inflation associated with the full employment zone.

After so many years of labor market slack, relatively high unemployment rates, and much excess capacity in manufacturing, the current situation represents a "sea change" of great importance for the U.S. and other economies.

A consequence of reaching the full employment zone has been rising inflation, most probably the demand-pull variety. Signs of accelerating inflation appear almost everywhere in recent months—in the major price indices, in wages, in commodity prices, and in the underlying sources of inflation.

Since the end of last year, the Consumer Price Index (CPI-U) has risen at a 4.5% annual rate, 4.6% over the past three months. The Producers' Price Index (PPI) is up at a 3.4% annual rate, 5.8% since February. The Commodity Research Bureau (CRB) is up a huge 14.7% since its low in mid-March and at a 26% annual rate since year end. Wages, too, are picking up, now higher by 3.4% over a year ago. Six months ago, the corresponding figure was 2.7%.

Thus, in this episode, the natural rate of unemployment seems to have been 5-1/2% to 6%, the region where inflation has accelerated.

Another consequence of the full employment zone is an increasing boom-like character for the U.S. economy. Boom-like characteristics need not occur with economic growth rates at stratospheric levels, but may reflect more the position of the economy relative to full employment output. With potential real economic growth at just under 2-1/2% per annum, economic growth rates of 3-1/2% or more can create a boomy situation. In U.S. manufacturing, a clear boom in exports has created a rush to prosperity, hectic production and hiring in several basic industries. In the regions with low unemployment rates, skilled and unskilled labor is tight and shortages exist. Consumer spending in the first quarter was up at a boomy 4.3% annual rate. Home prices in some areas of the economy continue to skyrocket, despite higher mortgage rates. These conditions all are characteristic of a boom, but are not yet fully spread throughout the economy.

Yet a third result of nearly full employment has been rising interest rates. Both short- and long-term interest rates are up one-half to one percentage point so far this year and nearly two percentage points since May 1986. The continuing business expansion, rising inflation, and ongoing federal budget deficits are mainly responsible. Such increases for interest rates must be termed gradual and reflect the emergence of a full employment environment. In postwar history, during times of extreme tightness and boomy inflation conditions, interest rates have risen several percentage points in a very short period of time. Such a condition does not seem in prospect at this time.

Overseas, most economies are behind the U.S. in reaching of full employment, especially in labor markets, not having achieved the kind of employment growth that has characterized the U.S. economy since 1982. Unemployment rates in Germany, France, and the U.K. remain high and employment growth modest. In the industrial side of the economy, the U.S. is enjoying a resurgence because of the lower dollar and lower currency-adjusted export prices. Other countries, Japan and Germany, for example, have shown much less industrial activity and exhibit lower utilization of capacity at this time.

The problem for economic policies in the U.S. is to somehow traverse the full employment zone without an unacceptable acceleration of inflation and the instability that has always created a turning point for the expansion and, then, a subsequent recession.

This task for policy is not easy; indeed, it has never been successfully achieved during the postwar years. At the current time, the Federal Reserve is attempting a "soft landing" approach to sustain the expansion with stable inflation and a stable unemployment rate. A fine-tuning of monetary policy in small doses to lean against growth and inflation is being attempted. The appropriate growth appears to be around 2-1/2%, on average, given potential real economic growth at 2.4% per annum. Growth significantly in excess of this would be highly inflationary.

But, monetary policy alone cannot achieve such a result, since so many other factors impinge on economic growth and the potential supply of the economy, including the federal budget deficit, private sector spending, rest-of-the-world economic activity, the dollar, and fiscal and monetary policies overseas.

One way to tone down economic growth to match supply would be additional budget restraint in the United States accompanied by some monetary easing, if necessary, to offset such restraint. Budget restraint or monetary tightness or some combination of both is the standard macroeconomic prescription to slow an economy.

For the U.S., many combinations of spending and taxes to tighten the budget can be envisioned that can work on both economic and political grounds.

A staged multiyear program of reductions to eliminate the $120 billion full employment or structural budget deficit should be the goal.

Modest declines in defense spending and a start toward burden-sharing with U.S. allies and trading partners can save $15 billion to $20 billion. Capping selected nondefense entitlements payments and aligning programs with inflation should result in $10 billion to $15 billion of saving. Hikes in excise or gasoline taxes to tone down consumer spending can raise another $10 billion. The resulting near one percentage point drop of interest rates that would occur and any further easing of interest rates by the Federal Reserve could save another $10 billion to $15 billion.

A $50-$40-$30 billion program of deficit reduction over fiscal years 1990 to 1992 is not large in a $4 trillion economy, but would be sufficient to remove the excess budget deficit. This would help prevent the economy from outpacing its potential and, through lower interest rates, shift spending more toward the capital-intensive productive investments that are needed to raise aggregate supply.

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Allen Sinai, Chief Economist

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Emerging Inflationary Spiral?

by Allen Sinai

U.S. inflation has shown a gradual acceleration over the past year or so, both in prices and wages. Is an inflationary spiral emerging in the United States economy?

Throughout the postwar period, inflation in the United States has undergone numerous ups and downs, and often has been characterized by an upward spiral. An inflationary spiral occurs when rising prices spill into costs, higher costs push up prices, then wages and unit labor costs rise in response, and wage costs cause prices to move up again.

Such a process, when in effect, has been hard to interrupt, generally requiring a major economic slowdown or recession to reverse the inflation. An inflationary spiral usually takes considerable time to unfold, often with only a gradual upward creep on inflation, and always requiring a reasonably strong economy to support the upward progression of prices and wages. Near full employment of labor and high rates of capacity utilization typically have characterized the economic environment surrounding such a spiral.

Over the past year, signs of an emerging inflationary spiral have begun to appear in the United States.

Price inflation, whether measured by the CPI-U, Implicit GNP Price Deflator, Fixed Weight Price Deflator, Consumer Goods Price Deflator or the Producers' Price Index (PPI), has shown a marked acceleration.

So far in 1988, the CPI-U has risen at a 4.6% annual rate; in the past three months, a 4.8% rate has been registered. The Implicit GNP Price Deflator is up at a 3.8% annualized rate so far this year and 4.9% over the past two quarters. The Fixed Weight Deflator has shown a 4.9% rise over the year and was up 5.3% in the third quarter. A year ago at this time, the Fixed Weight Deflator was rising at about a 3.8% annual rate. The Consumer Goods Implicit Price Deflator, viewed by many as the best measure of consumer inflation since it includes a full array of both goods and services, is up at a 4.1% annual rate and has risen by 4.9% over the past few months.

The PPI is showing the smallest increase, up at a 3.9% annualized rate this year. But, without energy and food prices, the PPI is up by a much larger 4.8%.

Wage inflation, too, has been accelerating. Average hourly earnings, adjusted for overtime and mix, a measure that does not include benefits and fringes, has risen 3.6% so far this year and is up at a 4.5% annual rate over the past three months. Year over year, this index has risen 3.4%. One year ago at this time, the year-over-year increase was 2.6%.

Other measures of wages also show an acceleration. The Employment Cost Index (ECI) is up 4.3% so far this year and jumped 5.3% in the third quarter. The corresponding figure a year ago was 3.4% over the same period in the previous year. Hourly compensation has been moving steadily higher, up 3.6% in the first quarter of 1988, then 4.2% in the second, and most recently at a 5.6% annual rate. The year-over-year rise is 4.9%. Hourly compensation has risen 4.3% in the year to date. One year ago, the figure was 3.3%. Thus, wage inflation has accelerated approximately three-quarters to one percentage point over the past year.

Why has inflation been creeping higher? The principal reasons are a long expansion and strong economy recently that have wiped out the slack that existed for most of the 1980s. The result is a classic demand-pull inflation.

By most measures, the economy appears to be in a "full employment zone," where rising demand presses against supply to push up prices and wages—a situation where too many dollars are chasing too few goods and, particularly in this episode, services.

Three measures can be used to gauge "full employment"—1) the "gap" or difference between potential GNP and real economic activity or real GNP; 2) unemployment rates; and 3) capacity utilization rates. All show a wiping out of slack over the past year and an economy near, but not at, complete full employment.

There no longer is a gap, with 72 months of expansion and seven consecutive quarters of 3% to 6% increases in real economic growth eliminating the shortfall between actual and real GNP. In the fourth quarter of 1982, actual real GNP was below potential by $382 billion or 11% of potential GNP. In the first quarter of 1988, actual GNP surpassed potential and now stands nearly $50 billion higher. This is the first time the gap has been eliminated since 1972-73. The previous instance when actual GNP was at or above potential GNP occurred in 1965 to 1969. In other instances of a strong economy and rising inflation, the gap at least narrowed. The gap always has been a good proxy for how much the economy was fully employed.

A measure of slack in labor markets is the unemployment rate, currently standing at 5.4%, measured on the civilian basis. This unemployment rate is the lowest since early 1979, but probably does not yet represent complete full employment in labor markets. Some 22 states show unemployment rates of 5% or lower, probably full employment in those states. With nearly half of the states showing full employment in labor markets, increases in wages are understandable. Slack in labor markets still exists, however, in the other 28 states where unemployment rates are higher.

Utilization rates also show an increasingly fully employed economy, but not completely so. The operating rate in basic U.S. industry is at 84.3%. In manufacturing, the figure is even higher, about 84.5%. However, only 25% to 30% of basic industries are at or above previous peak operating rates. Thus, the production-side of the economy is not yet completely employed. But, the industrial markets are increasingly tight.

With current price and wage inflation showing up at 4-1/2% to 5%, the economy essentially out of slack and economic growth still quite strong, the diagnosis of demand-pull inflation seems appropriate. *History teaches that once in place, a demand-pull inflation is slow to leave; instead, it builds up, usually gradually, until it triggers some policy response or other events that weaken the U.S. economy and, in turn, bring down inflation.*

Demand-pull price pressures often characterize the first stage of an inflationary spiral, usually set off by factors such as policy stimulus, wars, or in this case a big decline in the dollar and continuing stimulative federal budget deficits. Private and public sector demands are pushed much higher relative to supply and cause price inflation to accelerate. With strong demand and a disappearing of slack in the economy, cost-side pressures build, first on materials and then wages.

Once costs start to accumulate, the pricing practices of American business suggest even higher price inflation. The mechanism is markup pricing over costs, which may be used easily in a fully employed economy. Next, wage-earners begin to bargain for higher wages to compensate for the higher price inflation. Wage compensation and unit labor costs rise more and another rung in the ladder of the inflationary spiral is put into place.

Since the mid-1970s, an important element in the inflationary process was oil and energy prices. From 1974 to the early 1980s, rising oil prices were a major source of inflationary pressure in the U.S. economy, with and without the demand-pull element present. For much of the 1980s, falling oil prices tended to help propel inflation rates downward. Thus, oil prices, thought to be an external factor, or a "shock" element in the inflation process, has both made inflation worse or provided an escape valve to prevent inflation from worsening.

Currently, the oil price factor has turned negative for inflation in the United States. The recent OPEC Agreement in Vienna prevented a big decline in oil prices and probably a one percentage point drop in the U.S. inflation rate from occurring. Production quotas and a settlement of differences between Iran and Iraq make $15 to $16 a barrel oil prices likely for the next four to five months. It is not so much that U.S. inflation will rise off the OPEC Agreement that is negative for the inflation outlook, but that oil and energy prices *will not fall* to cause a deceleration in inflation.

With the economy near full employment, growing at a strong pace and above potential, materials costs and wage costs beginning to build and no escape valve this time from lower oil prices, the inflation rate in the United States seems headed higher—in the first half of 1989 to a 5-1/2% annualized rate, on average, and then perhaps 6%.

At this level, U.S. inflation would be well in excess of inflation in many other countries. Japan, for example, currently is showing less than a 1% rate of inflation. The rate of inflation in Germany is only 1.4%. Canada's rate of inflation is approximately 4%. France is showing a 3% rate of inflation. And, the U.K., although showing higher inflation than in the U.S., has taken strong steps to combat it. The U.S. central bank seems lax against an inflation rate of 5% compared with the monetary policies of Japan, Germany, and even the U.K.. Japan is not likely to tolerate 2% or more inflation. Germany already is tightening monetary policy on an inflation rate in excess of 1%. The U.K. is standing strong against inflation this time around, having raised the base lending rate by 5-1/2 percentage points since July.

In such a situation, the dollar will tend to decline off the inflation differentials, adding to the inflationary spiral, both through demand-pull and cost-push. A lower dollar stimulates exports, orders, production and creates pressure from aggregate demand on industrial capacity and thus higher inflation. A declining dollar directly raises the prices of imported goods, which are prominent in the shopping bags of American consumers and businesses.

The inflationary spiral thus seems likely to continue, gradually, but with rising price and wage inflation rates nevertheless, until basic policy changes are taken in the United States to slow the economy. This means tighter fiscal policy and tighter monetary policy, or some combination thereof, then a weaker economy, and finally a falling inflation rate.

The lesson of history, however, is that inflation tends to recede slowly, especially once entrenched and if a consequence of demand-pull factors. The odds are that the inflationary spiral will intensify before it lets up!

THE BOSTON COMPANY
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Allen Sinai, Chief Economist

Economic Advisors, Inc.
(Boston-New York-London-Tokyo)

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Inverted Yield Curves—The New Trend

by Allen Sinai*

The U.S. Government yield curve has flattened and now is inverted over a large range of maturities. From a one-year term out to other maturities the spreads relative to the Treasury bond rate vary from a few basis points to nearly 20 basis points.

The U.S. is now the fourth major country to exhibit a flat or inverted yield curve. The U.K., Canada and Australia are the others. In Japan, the interest rates on various maturities, of Gensaki and the longer-term securities except for the 10-year bond, show a flat to somewhat inverted pattern.

The inverted yield curve pattern that has been emerging, recently at a quicker pace in the U.S., is familiar and characteristic of the late stages in U.S. business expansions.

Inverted yield curves always have been a consequence of high inflation and the reactions of the Federal Reserve to stem that inflation.

Once inflation moves higher than some threshold rate permitted by the central bank, tighter monetary policy is pursued. The allowable inflation has differed from episode to episode, with each central bank group standing against inflation at a different level. The level of inflation permitted often is rooted in the politics and institutions of the time, with the bulk of the central bank having been appointed by one, or at most, three administrations. When the country at large is relatively lax on inflation, for example, then so will be the Federal Reserve, and vice versa.

Early on, the central bank leans against economic growth and inflation, tilting short-term interest rates higher. Typically, market participants expect higher short-term interest rates to slow the economy and to reduce inflation, setting up expectations effects that hold down the long end of the yield curve—at least for a time.

However, the central bank's early actions to rein in inflation most often do not work well and further tightening is required. The yield curve then becomes even more inverted, with market participants still expecting weaker economic growth and lower inflation to evolve.

The problem is that it takes quite some time for the economy to weaken off rising interest rates and even longer before inflation falls in response to a slowing economy. Once the markets recognize this, the long end of the yield curve gives way, and long-term interest rates move higher. With inflation still entrenched, the short end keeps moving up, maintaining the inverted yield curve for quite a while longer.

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* *Based on an article to appear in the Japan Economic Journal.*

Indeed, in the episodes of inverted yield curves since the mid-1950s, flat to inverted yield curves have stayed in place for at least five quarters (1973-74) and as long as 11 quarters (1968-70). A one to two year span represents the modal experience.

The emerging pattern this time around is thus familiar, with one new element—the expectation of a stronger dollar as short-term interest rates rise to hold down long-term interest rates. *The same lags as in other episodes—between a tightening of monetary policy, a slowdown in the economy, a weaker economy, and then less inflation—still apply.* As wage costs move higher as part of the inflationary process, then cost-push factors delay a decline in inflation. If strong economic growth and Fed tightening is the source of the higher short-term interest rates, more inflation is likely to develop than the disinflation from a firm dollar.

Once in place, an inverted yield curve represents a new trend, likely to persist for some time.

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The Boston Company Economic Advisors, inc
American Express Tower
New York, New York 10285-1200
212 298-6030

The Boston Company Economic Advisors, Inc
One Boston Place
Boston, Massachusetts 02108
617 722-6820

[illegible]

THE BOSTON COMPANY
Boston Safe Deposit and Trust Company

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(Boston•New York•London•Tokyo)

Allen Sinai, Chief Economist

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1989: Year of Restraint?

by Allen Sinai*

This coming January marks the 75th month of the current U.S. business expansion, now the second longest in the postwar period next to the record 106-month upturn between 1961 and 1969.

In 1989, those very factors most responsible for the long and, in the past year-and-a-half, quite strong upturn could prove decisive in its undoing.

First, the great amount of slack that permitted so much growth and declining inflation rates during the early to mid-1980s has now given way to a nearly fully employed economy with rising inflation. With the economy beginning to bump up against capacity limitations and some labor shortages at existing wages, the pace of real economic growth must eventually slacken even as inflation keeps picking up.

Second, the stimulus of massive federal budget deficits, so critical to the economy's strength for the past six years, remains; only now a potential source of too high inflation, too large a supply of dollar-denominated debt for the dollar to be sustained at current levels, and a constraint on the Federal Reserve that prevents a lower profile of interest rates. Budget deficits are a big plus in an economy with unutilized resources; but a big negative when slack is gone and inflation is of concern.

Third, still large trade and current account deficits in the U.S., a source of a rolling readjustment in the economy and welcome slowdown during 1985 and 1986, remain to push the dollar lower, nudge inflation up, and as a source of upward pressure on interest rates so as to attract foreign funding. The combination of higher inflation and higher interest rates can squeeze the purchasing power of the private sector and, with lags, send the economy lower.

Fourth, declining inflation in a slack economy with large supplies of goods and services and intense competition served as a major force driving up real income, real wealth and the economy between 1983 and 1987. Falling oil prices also were beneficial, reducing inflation and helping to keep interest rates low. Currently, oil prices are on the rise, up $3 to $5 a barrel in just the past month or so as OPEC cuts back on production and strong world economies push up the demand for oil and energy.

Based on an article to appear in the Tokyo Chunichi Shimbun.

But now, a gradually rising rate of inflation is the by-product of near full employment, acting to diminish real purchasing power and wealth and ultimately to weaken the economy. In addition, higher inflation pushes up interest rates, another ingredient in any economic squeeze.

Fifth, Federal Reserve policy, the main tool used to enhance and sustain the expansion since 1982, now must turn toward restraint rather than stimulus. The U.S. central bank cannot really tolerate inflation rates of 4-1/2% and up, and has been leaning against strong growth in the economy and high inflation through short-term periodic small hikes of interest rates. To sustain the expansion without a further acceleration of inflation requires a tighter monetary policy. This represents a sea change from earlier years, when monetary policy could be used to stimulate the economy without fear of too much inflation.

For the Federal Reserve, this year's "soft landing" strategy has not succeeded. Real economic growth ex-drought remains well above the central bank target of 2% to 2-1/2% set for the second half and inflation is running at 4-1/2% instead of the targeted 4%. The Federal Reserve will be a hindrance to the economy in 1989, with the only unknown how much and how fast interest rates must be raised in order to limit economic growth and restrain inflation to the desired lower levels.

The approach to full employment in the U.S. economy already has produced a gradual acceleration of inflation—4-1/2% to 5% this past year and likely reaching a 5% to 6% range in 1989.

This inflation, although not high by comparison with the extraordinary double-digit episode of the late 1970s and early 1980s, is historically high relative to most other postwar experience. U.S. inflation is high relative to Japan, Germany, France and Canada, and therefore a source of potential downward pressure on the dollar.

In 1989, high inflation and dollar weakness will combine to produce higher interest rates, both from Federal Reserve tightening and market forces, until the economy enters a major slowdown or perhaps even a recession.

The economy should remain strong into the New Year, showing 3%-plus gains for another quarter or two. The unemployment rate can be expected to reach a low of 5%. Higher inflation and one-half to one-and-a-half percentage points higher interest rates should squeeze spending down by the second half, sending real economic growth into negative territory by the fourth quarter.

For the year, real growth of 2% to 2-1/2% is likely, fourth quarter-to-fourth quarter, but sliding sharply in the second half. Escape from this scenario lies in surprising luck occurring on inflation, significant deficit reduction early in the Bush Administration accompanied by an easier monetary policy, or longer lags in the response of the economy to tighter Fed policy than typically occur.

For U.S. financial markets, 1989 promises to be another year of uncertainty, with considerable trading in ranges set by growth in the economy, inflation and Federal Reserve policy, and the dollar. Interest rates, both short- and long-term, can be expected to rise irregularly during the first half, especially as the Federal Reserve tightens more to rein in the economy and limit inflation.

With an economic slowdown the goal of the central bank, profits growth momentum must ease off as well; if not in 1989, certainly in 1990. This, along with higher interest rates, may not bode well for the U.S. equity market. The Dow-Jones Industrial Average can be bounded by approximately 2300-2400 on the upside and 1700 on the downside, the latter only if a recession comes into view.

For the dollar, further declines, on average, can be expected, principally a consequence of higher U.S. inflation than in other countries, still high budget and trade deficits, and financial asset diversification across countries by foreign investors.

Should the peak in economic activity for this expansion be reached some time in 1989 and a clearcut slowdown or recession emerge, long-term interest rates would move sharply lower and easier Fed policy could take short-term interest rates down as well. A new move upward in the U.S. equity market would lag, awaiting the outcome of any possible recession.

Before a significant turn can occur in the economy and U.S. financial markets, however, considerable restraint may be necessary. 1989 is likely to be a year of restraint, probably from the central bank. Much could be accomplished if fiscal restraint was also used to combat the inflation that has emerged in the United States.

Representative HAMILTON. Think you very much, gentlemen. We will begin questions now and proceed under the 10-minute rule.

Let's begin with high-definition television.

Now, I caught a Washington Post article this morning, which relates, Mr. Chimerine, to what you were talking about, the competitiveness problem. And the fundamental question is: Is this the way to go? Here we are talking about a concerted government effort on high-definition television operated out of the Defense Department, basically. There are a lot of proposals out there. Relaxing the antitrust laws, low interest Government-guaranteed loans, tax breaks for this particular industry, and perhaps other matters, too.

But it smacks to me of what many years ago used to be called "industrial policy."

Now, we already have other examples of this. Are we working ourselves now into a position where the only way we can keep U.S. competitive or even with our competitors across the world is to move into some kind of targeted industrial policy, whatever you want to call it?

It this a wise thing to do, or an unwise thing to do?

Mr. CHIMERINE. Mr. Chairman, you are asking a very relevant and difficult question. My conclusion on that is based on the following premise, that:

First, there is no evidence to suggest yet that there has been a fundamental ongoing improvement in productivity growth. And that has to be the highest national priority.

Second, it is a multidimensional problem. I think most of us who have done a lot of work on productivity have not been able to isolate one factor that has caused the productivity slowdown over the past 15 years.

It seems to me, you know, a number of factors, each making a small contribution, have caused the problem.

And, third, I would conclude from that that if we are going to accelerate productivity growth in the future, we are going to have to address a number of different issues, not just one.

For example, the quality of education is becoming increasingly important as part of the competitive problem. Every measure that I look at shows that the gap between the United States and most of our foreign competitors is widening against us.

Representative HAMILTON. Very long term.

Mr. CHIMERINE. Very long term. We are underinvesting, even with the modest pickup in investment in the last year or two. Net investment relative to GNP has been lower in this decade than in previous decades. We really have not had a supply-side revolution; contrary to what my friend and colleague, Dick Rahn has mentioned, this has been a demand-side recovery.

I mentioned earlier that productivity growth is still very strong elsewhere. There are gaps. The R&D gaps are widening against us. There has to be increased public and private investment. And if you call industrial policy—but I don't know whether the best answer is to provide incentives, or relaxed antitrust laws for private companies to band together to do this, or whether government funding would be necessary and some government participation is necessary.

Representative **Hamilton**. How do you react when you read about the Government participation in high-definition television? Do you know?

Mr. **Chimerine**. I'm not sure that is the best way to achieve the objective. I am concerned. But, if we don't change the way we've gone in the last several years, in my judgment, we're going to fall behind very quickly, as we have done in a number of different industries.

Whether this is the ideal solution or not, Mr. Chairman, I honestly cannot——

Representative **Hamilton**. I want to hear from the others on this, too.

Mr. Rahn.

Mr. **Rahn**. I don't have any firm stand on that particular proposal, but I tend to be a skeptic of industrial policy. And I think all of us probably agree that we do have a problem with education in this country. There are a lot of reasons why our education performance has not been what it should be. I think a lot of it is because of too much monopoly at the lower levels of education.

But, it is also very apparent that the United States has a higher cost of capital than many of our industrialized competitors, particularly Japan.

This is something that you folks can do something about by changes in the tax structure to make our cost of capital more competitive with the other major industrial countries.

And if we did so, we would have, I think, less need to try to go ahead and look at particular industries who may then not be having a particular problem.

I would tend to shy away from industry-specific incentives and focus on the cost of capital.

Also, antitrust is something perhaps you can do a bit more about. Clearly, as we have moved into a global economy, the concepts that we had of antitrust when most of us were in school are largely irrelevant these days.

Some further adjustment in the antitrust laws is required to allow American firms who need very high amounts of capital investment to get into new industries, could be allowed to combine to do so. That might be desirable.

But I don't think that I would go much beyond that.

Representative **Hamilton**. Mr. Sinai.

Mr. **Sinai**. I would say yes, we want to be competitive with credits and subsidies and favorable treatment to speed along the ability to compete worldwide. Other countries do this and set priorities for their industries, and have had great success in the world competitive arena.

I would say though that such measures would have to be done with strings attached—low funding and in a venture capital kind of way, with results demanded in a fairly short time—perhaps results in achieving more worldwide competitiveness. And, any measures should be in the private sector with help from the Government, but not Government management or control.

Is this industrial policy? Industrial policy probably has a bad name and connotation politically over the past few years.

Representative **Hamilton**. What's a better one?

Mr. **Sinai**. A program for increased competitiveness to rally the country to compete better in the emerging and targeted areas where we want——

Representative **Hamilton**. It doesn't bother you that we have picked up high-definition television as a target now?

I know very little about the importance of high-definition television.

How does it strike you? Is it a good thing to do?

Mr. **Sinai**. That is our third point.

Representative **Hamilton**. There must be a hundred others.

Mr. **Sinai**. That's right, they will all be coming down.

Representative **Hamilton**. You can bet on it.

Mr. **Sinai**. The problem is to figure out which ones. But there may be, in some cases for example, semiconductors or high-definition television, a collective social opinion on it. And if so, it is something worth doing.

I think fair trade is what we want, in my opinion.

And trade is not so fair if other countries use tactics to increase their competitiveness and snare our share from us, and then we cannot quite get it back.

I think we have probably run the string too long in letting that kind of thing go on in the competitiveness arena. There are economic reasons why we are at a competitive disadvantage as well. The overall cost of capital is one; our debt position is another.

But, here is the chance to do something to help certain industries that we feel would be the ones that we want to stress.

Mr. **Chimerine**. If I can make a comment.

I guess we all have different answers to that question. And I don't think any one of us has a firm opinion on that particular case, but I think you are asking the right questions. I think the fundamental question has to be:

What role is the Government or should the Government play in improving our competitiveness in world markets and accelerating the trend in productivity?

And that has not been a question that has been debated, and I think that is a very big question in the entire budget deficit debate. We are now going about cutting the budget deficit, in my mind, without asking the question:

What is the appropriate role of government? What should we be funding? How can government help in the process of building more effectively for the future?

And I think these are the questions that have to be debated and whether this particular case should be funded by government or some other, I don't know. But we have to have a national debate and decide what role government will play and what specific kinds of projects government will fund.

And until now, it has been a neglected issue, in my view.

Representative **Hamilton**. It is interesting to hear the way the three of you respond. Two of you talk in your response more about changing fundamentals—investment rates, education, research, and so forth.

Mr. Sinai, you seem less bothered by high-definition television subsidies than others and seem more prepared to support it.

Mr. **Sinai**. High definition is a generic term that can mean something else. But our problem in our country, in the corporate sector as well, is that we cannot make allocation decisions. We cannot pick out the winners from the losers; that is very hard to do in a domestic society.

And that's OK. I'm all in favor of that. The difficulty is that our competitors are making those decisions and are leaping forward ahead of us, day after day.

The corporation cannot decide——

Representative **Hamilton**. That is the problem with the approach they are suggesting, in a sense. I don't mean to be critical. I would say the same thing in a response to the question.

But, education, investment changes and so forth, are really quite long term. And I'm not saying that we shouldn't do those. Obviously, we should.

Mr. **Rahn**. I want to add one thing to that.

Countries which have tried to make these investment decisions and pick winners and losers have not been all that great at it. We talked about the Japanese, what a wonderful job they did.

But the Japanese ended up overinvesting in shipbuilding. They had largely to dismantle that industry. They overinvested in steel.

And our last attempt in this country in a major way was the synfuels projects. And we all thought that was something very important. It turned out to be in many ways a national disaster. We all misforecast oil prices and we wasted billions of taxpayers dollars.

I'm not sure that the wisdom here on the panel or the Congress is better than the marketplace. It seems to me historically that if the marketplace is given a level playing ground, that individual citizens and business people will make decisions correctly.

Representative **Hamilton**. Congressman Solarz.

Representative **Solarz**. Mr. Chairman, I think Mr. Sinai——

Mr. **Sinai**. One could take a billion or two or three out of SDI funding and sprinkle it to 30 or 40 or 50 little venture capital cases. Use subsidy or tax credits. And if only three or four work out, that's fine. The rest may not work out.

But I would say that is not a bad investment decision for the Government to make. No strings attached.

Senator **Gore**. If you would yield for a brief followup.

Would you say that overall Japan has been a failure?

Mr. **Rahn**. No, not overall. But I would say that they had specific failures. We have had specific failures and the evidence to me is that the Japanese have succeeded much more so because they have had a very strong educational program and they have treated capital investment much more favorably than we have in their tax code.

Senator **Gore**. But they have targeted—and I will not pursue this because it is not my time, but they have targeted a lot of things.

The fact that a few of them didn't pan out doesn't mean that it wasn't brilliant for them to target automobiles and computers and now superconductivity and biotechnology, and spread the risk associated with those targeted investments broadly throughout their insurance and banking systems and throughout their entire society—to focus the efforts, set long-term goals, come up with a concerted plan to hurdle the obstacles that they identified, and take over the world market.

They have done pretty well at that, it seems to me.

Mr. **Rahn**. There is no doubt in a number of cases they have been very successful. But they have also had some notable failures.

And I also think we have to realize that we are not the Japanese. We are not a homogenous society in the way that they are.

I am not sure we can ge the same kind of a consensus and discipline. We're Americans. We're a less centrally disciplined society. That doesn't bother me.

But I don't think we ought to try to be something that we're not. And we would probably have a greater chance of failure at these things than they do.

Representative **Hamilton**. Congressman Solarz.

Representative **Solarz**. Thank you very much, Mr. Chairman.

Gentlemen, I have the impression you all agree that we are going to have to deal with the problem of productivity. And, among other things, we have to substantially increase investment. And that, in turn, appears tc be related to the relatively low-savings rate which we have and the need to increase that.

I would appreciate it if each of you could share with the committee your thoughts as to why the savings rate is so low, particularly in relationship to other industrial countries in the world.

And, second, given the mix of factors which have contributed to the low-savings rate, what, if anything, do you think we can do as a nation to increase the savings rate to a point where it would be compatible with the national requirements for investment to improve productivity?

Mr. **Chimerine**. I think that is an essential question. I think the challenge of the next 10 years is to increase savings and to find ways to channel those savings into more productive investment, some of that being public investment, some of it being private investment.

And I think the question you ask is sort of complicated because one of the reasons why our savings rate in this country is lower than our foreign competitors is purely a measurement problem.

However, what is most disappointing to me is that we have enacted a whole batch of new programs, incentives, if you will, over the last 7 or 8 years. And other conditions have prevailed, all of which at least at the margin should have been positive for savings. We now have 401K's, Keogh's, IRA's, and so forth. We have the highest real interest rates—I don't even know in how many years—perhaps 50 years. We have had marginal tax rate cuts.

All of these were supposed to increase personal savings; yet, by every measure we have, the personal savings rate has come down. This is just not a savings-oriented society. I think some of us think that the typical family sits around the kitchen table on Monday morning and ask:

"How much are we going to save this week? Let's look at the tax structure."

That is not the way people make that decision. We are spenders, particularly the younger generation that has never lived through relatively tough times. I don't know at this point, to be honest, what we can do to increase private savings.

That's why I feel very strongly about cutting the budget deficit. The only way that I am aware of that is guaranteed to increase national savings is to make a large reduction in the Federal budget deficit.

In fact, picking up on what Richard Rahn said a few moments ago about the cost of capital, I think the biggest thing keeping the cost of capital high is our budget deficits.

Representative SOLARZ. If I could interject, how much of the Federal deficit is financed by the foreign purchase of T-bills? What percentage?

Mr. CHIMERINE. If you mean what percentage of Treasury auctions are being purchased by foreigners, I think it is 30 to 40 percent. At least, that is the average for the last couple of years.

Allen Sinai might have better data on that than I do. It is in that range. But I don't know if that is a meaningful way of measuring what you're after.

Nonetheless, to answer your question directly, I think——

Representative SOLARZ. Your argument would be that the 60 to 70 percent of the Federal deficit which is financed by domestic purchase of T-bills, if we substantially reduce the deficit, would then be available for investment.

Mr. CHIMERINE. Potentially.

Representative SOLARZ. Potentially. Please go on.

Mr. CHIMERINE. I think part of that may need to be used to finance public investment. For example, we have neglected the infrastructure in this country.

I think there's potentially some programs that the Federal Government can fund in job training or retraining. Some of the things that Allen Sinai mentioned deserve some consideration and if we build a national consensus to do it, some of that money can be used to fund specific programs, at least partially fund private sector research programs.

But, to answer your question directly, I don't know what to suggest to you to increase national savings other than cutting budget deficits.

Mr. RAHN. You have three different sources of saving, corporate savings, personal, and public. In the public arena, we all realize the total government sector is running a deficit at this point. And it is desirable to get the deficit down.

Representative SOLARZ. When you say the total governmental sector, you are including State and local government?

Mr. RAHN. Yes. The total government deficit runs about 2.5 percent of GNP. The Federal Government deficit is a little over 3 percent, about 3.4 now.

There is a surplus at the State and local levels. So, clearly, if you reduce the deficit, it helps raise public savings.

I have a very strong difference of opinion with Mr. Chimerine on the reasons individuals and business don't save.

And that is, in my judgment, very much because we have the Tax Code bias against saving. However, you don't instantaneously change behavior.

He is right. The people don't sit at the dining room table and suddenly figure out their aftertax rate of return.

During the 1970's, it amazed me how much individual savings we had, when most people were getting negative rates of return because the combination of inflation and taxes was higher than what people thought they were actually achieving.

But, even now, if you have a typical bank savings account, it will bring 7 percent interest. A quarter or more of that interest for the average person would be paid in taxes, so they have 5 percent left over. Inflation takes 4 percent. So they have maybe a real rate of return of 1 percent.

The evidence from the National Bureau of Economics studies on IRA's, suggests that IRA's were having an impact on the amount of new savings, but then they were cut out before they really had a chance to work.

We have the highest rates of capital gains tax among the industrial countries and higher rates of taxation on interest dividends and capital gains than most other countries. Hence, you would expect a lower rate of savings.

Now we think it is desirable to reduce the impediments to saving. If you reduce them, you're not going to get an instantaneous change in the first 6 months of the first year. It takes a while for people to adapt to new incentives.

On the corporate side, we still have a number of disincentives, particularly for long-term investment. These are the capital cost recovery allowances, for instance. We have the same problem on the corporate side where debt is deductible, but we have the double taxation of dividends and high corporate capital gains taxes.

So you find over a longer period of time people will respond to tax incentives.

Some of the observed low rates of saving are demographically induced. We will be having a rising age of the population over the next couple of decades, and that should cause the natural rate of savings to rise somewhat.

There has been a lot of argument to the extent that people perceive Social Security as savings. You mention measurement problems. Most people have the bulk of their savings in their home equity, but that is not considered savings under the national income definition of savings.

Clearly, we want more savings channeled into productive investment, into new ventures, into productive corporate capital.

And it seems to me it should be obvious the way to do that is to reduce the cost of that relative to consumption.

Representative SOLARZ. Mr. Sinai.

Mr. SINAI. Under the reasons why, I think it is largely cultural. It is hard to find economic reasons why we continue to save so little. There is a desire to spend, insatiable spending by American consumers.

I asked my Japanese friends, my Japanese clients. They will giggle and laugh and say, "Well, it is in our culture."

And now when people ask me—I used to give a long list of reasons, and my answer is that: "It's in our culture."

There are other tangible reasons. I think we have a lot of savings for retirement that goes on here that does not go on, for example, in Japan. There's much more of a need to save for retirement there than here.

In pensions and other kinds of funding, a lot of savings goes on for us.

Also, in the 1980's, we had substantial wealth effects. There were very large increases in the value of household wealth. True real estate appreciation as well as stock appreciation.

And that tends to depress the measured personal savings rate.

Given our society, I think the step is to reduce interest rates, to lower the cost of capital and to get capital spending up, not so much to get the saving rate up.

And that is the budget deficit issue.

Representative SOLARZ. If I may ask one final question, which raises perhaps the flip side of the question on savings. And that has to do with the enormous accumulation of debt in our society.

How serious do you think this is, as a kind of overhang on the economy? And what, if anything, do you think should be done about it?

Mr. SINAI. The debt problem to me is most serious this time in the Federal Government sector and in our international accounts.

I have studied this in all of our business cycles rather thoroughly in terms of private sector accumulation of debt and various financial problems that arise.

We have a lot of absolute debt and debt growth in the private sector. But, in relation to income and interest charges, in relation to incoming cash-flow, they are not really serious and onerous yet.

The problem stands out like a sore thumb in the Federal Government area. There is a tremendous amount of Treasury debt, and increasing interest charges on that debt. Interest charges on the Federal debt for 1990 will run the same as the deficit used to be a proportion of GNP, and now we have international indebtedness as well.

It is well overestimated. It is not correct. But the trend is very clear. It is the public sector debt and our international indebtedness that is really the problem we have this time around. And the one that I think in the long run is what I meant when I said we were mortgaging the future far beyond the next decade for these deficits.

Mr. CHIMERINE. I would agree with that. I would also conclude that we have made the economy a lot more risky than it has been at any time in the last 30 to 40 years.

But nobody can give you a precise answer. We have somewhat of an unprecedented situation. It is hard to work it through.

But my concern is that we are borrowing from the future. And, second, the economy is more risky now; the risk of a substantial downturn is higher than it has been in the last 30 to 40 years.

Mr. RAHN. May I make one point on that?

I have a little different viewpoint, as I typically do with my colleagues here. I prefer lower levels of debt rather than higher levels, but the key thing is what do you use the debt for? Do you use it for productive investment, or for consumption?

To the extent you use it for consumption over the long run you will be in trouble.

On the public debt though, I think some of the concern has been overstated. And there's often argument that we're putting this burden on our children.

But, if you look at the amount of Federal tax in inflation-adjusted terms and adjust for the size of the population, you find that it has fallen from about $12,700 per capita to about $7,800 per capita since 1945. And in many ways, we are putting a smaller burden on our children than our parents put on us. I'm glad our parents put on that debt because they used it to win World War II, and that was a very constructive use of the money.

And I don't think any of us would second-guess them for a moment.

Clearly, you do not want the public debt rising as a percentage of the GNP over the long run. That is undesirable.

Allen Sinai referred to the growth in interest rate payments. That is clearly a source of concern. However, we argue that we can bring down the rates with some changes in monetary policy, but we're not at a crisis stage.

We look at the Italians who run a deficit of 12 percent of the GNP and their economy still is growing. It is not the end of the road for them.

And our total debt probably averages about that of the OECD nations.

Mr. CHIMERINE. If I could make one quick comment.

If you look at the history of the last 8 years, you have to conclude that a large fraction of that debt is essentially going to fund current consumption:

Financial transactions, building empty office buildings in Texas, consumer spending and current consumption within the Federal spending, and so forth.

I think that is disturbing.

Second, the real way of calculating the burden of the Federal debt is not just by adjusting for inflation and all of the other fancy adjustments we economists make. It's the fact that it accounts for a much larger share of credit market activity, of national savings, than ever before; and, second, the burden of financing that debt, federal interest payments as a share of GNP, is far and away above anything we've ever had before in our history.

To me, there is a big burden. And I think it is being understated by some of these adjustments that are being made.

Mr. RAHN. We have one disturbing trend. And that is the increasing tendency of the Federal Government to guarantee loans, or insure loans. And that, in many ways, has the same type of ramifications as the Government actually incurring the direct debt.

On that basis, debt is growing rapidly and I find that dangerous.

Representative HAMILTON. Senator Gore.

Senator GORE. I want to come back to this discussion. I did want to make a point as a result of the interchange that you and I had in Congressman Solarz' time earlier.

Mr. Rahn, when you said we are not Japan and we cannot behave like Japan, I, of course, agree with that.

I heard a speaker not long ago draw an analogy to the Olympics that I thought made a useful point, He said that:

"If we wanted to win more gold medals in the Olympics, we would look at what's going on."

East Germany with 17 million people wins a lot more than we do with 240 million people.

If we decided as a matter of national priority that we wanted to win more gold medals at the Olympics, we might look at what East Germany is going and conclude that selecting children in kindergarten for their potential as athletes in particular events—it is important to our value system and other things that what they do would be unacceptable to us, and we wouldn't do what they do, even if we made it a national priority to win more gold medals.

But, if it was important to us, we would have to take into account the fact that East Germany's methods are posing a challenge to our former dominance of the Olympics. That is completely different from anything we have faced before. And while we would reject their methods, we would have to conclude that our current methods are not sufficient to win more gold medals at the Olympics.

If we decide as a matter of national priority to become more competitive in world trade, we might still reject some of the methods and solutions chosen by Japan. But we cannot fail to take into account the fact that their methods are posing a challenge to us competely different from any that we have ever faced before.

And it is very difficult to resist a conclusion that our traditional methods and approaches are no longer sufficient. The scientific and technological revolution is accelerating in its pace and intensity.

The period of time between basic discovery and marketable product has been telescoped from centuries to years. And sometimes even less than that.

The basic discoveries still come out of the research apparatus that we have created in the United States, par excellence, and yet the discoveries and breakthroughs are harvested in scientific and technical publications and research fellowships and joint ventures and in other ways.

And with Japanese methods using them as a symbol for the model they had pioneered, they are turned into marketable products at a rate that leaves us way behind.

We have seen it in electronics. We are seeing it now in some of the new areas, as I mentioned, superconductivity being among them. High-definition television is one that we can clearly see that will almost certainly be a winner in the economy of tomorrow.

So it just seems to me that it is no longer sufficient to say everything will work out. I don't think it will. I think we have to adapt to the new scientific and technological environment that exists out there.

I will give you a chance to comment briefly if you would. I just want to make that point.

Mr. Rahn. I don't think that I ever said that we ought not to do anything, that we ought not to make changes.

I talked about the necessity of reducing the cost of capital and improving our educational system. I am a skeptic to determine when it comes to governmental targeting of industries which are winners and losers.

I think, first of all, we tend not to be as wise as we often think we are and all of us, both inside and outside of government, by the nature of our political process, congress tends not necessarily to allocate resources the best way they ought to.

And I don't mean it as a criticism of you gentlemen. You are here to deliver for your own constituents.

Senator **Gore**. I agree with you. I think that point is well made.

Mr. **Rahn**. I tend to be a real skeptic of industrial policy.

Now, clearly, our cost of capital is higher than the Japanese. We know that, and we also know we can do something about that.

Senator **Gore**. It's not just the cost of capital. You see, here's where I disagree with you.

You identify problems and difficulties that would be associated with any sort of targeting arrangement. I can see them. I agree with you that the political system is so sensitive to factors that have nothing to do with what technology is going to give us the biggest payoff and what opportunities we can fairly judge to be the best as we take an objective view of the world economy of the future.

I understand all that. But, then to jump from that to a total rejection of any nature, of any effort of that kind to the conclusion that, well, it just comes back to cost of capital and we have to give business lower cost of capital and they will solve it. I mean we have to create a new American model for spreading risks and focusing effort on areas of technology and science and investment where obviously the competition is going to be the hottest.

I don't trust the political system to do that either.

But I don't trust the Rotary Club to do it or the Boy Scouts or one individual company that doesn't have the capital to make the investments on a scale required.

And somehow business and government and universities and labor have together to find a new American model that respects our traditions and values and maximizes the wisdom of the market system, which is one of our greatest strengths and yet, nevertheless, allows us to give an extra surge in the areas that are clearly there; because it is not a laissez-faire world environment out there. Our competition is coming in and saying, bam, this is it. And they're winning.

I mean, they are winning. You don't doubt that, do you?

Mr. **Rahn**. I think the Japanese have won in certain specific industries. I mean, clearly, they captured the bulk of worldwide TV markets. We produce relatively few TV's in this country any more.

I think I understand what you're saying and, philosophically, I cannot disagree with you. It comes down to: What are the specific proposals?

Senator **Gore**. Yes.

Mr. **Rahn**. And, I just am skeptical of our ability to operate like the Japanese.

Senator **Gore**. We have to go beyond skepticism to something creative. I think I am as guilty as anybody.

Mr. **Rahn**. I am all for creativity. I'm not opposed to new initiatives. But, as long as we learn from our past mistakes and also look realistically at the kind of political system we have and the political pressures on us, I don't want us to get into a situation where we allocate scarce national capital through political means. I am not sure how we can reduce barriers for cooperation between universities, business, governments, and so forth, but I am all for that.

But, I still think of synfuels.

Mr. **Chimerine**. Senator, I think you're absolutely right. In fact, I think we've had a tendency in this country in the last 10 years or more to justify neglect by the catch phrase laissez-faire. There's been a lot of neglect and indifference in this country on these issues.

We no longer have the dominance we did 20 years ago. Everybody's caught up to us and is going ahead of us. I think we absolutely have to redefine the role that government is going to play in this process.

I don't know what the right answer is, but, for example, if we're going to get better cooperation between the universities, business, and labor, it is not going to happen by itself.

Maybe government has to be the catalyst. Maybe they have to provide the financing, maybe just reduce the cost of capital.

This is what the debate should be about.

Senator **Gore**. I agree with you.

Mr. **Chimerine**. I think it is critical even in addressing the budget deficit, because the last thing I want to see happen is sticking to rigid formulas, cutting the programs that are probably the most important ones for future competitiveness and productivity, which we have been doing in recent years.

The burden of the interest expense is squeezing out more productive kinds of spending.

This is what the issue is. And I don't know the answer, but I do know that we have to find an answer.

Senator **Gore**. I wish I had more time, but I don't.

Thank you, Mr. Chairman.

Representative **Hamilton**. All right. Congressman McMillan.

Representative **McMillan**. I apologize for being late. I had an organization committee meeting, so I will probably skip around a little bit.

Just one comment though on what the Senator was pursuing.

You take television sets, for example, we lost production because of a lack of technology know-how, or did we lose it because we didn't wager that much?

Because of wages?

Mr. **Chimerine**. At first, it was wage differentials. Then, later, they used their strength in export markets to develop new and better products and new technology.

Representative **McMillan**. But the point was wage differential. And I'm not sure industrial policy or even consortium is going to reconcile that disparity. It is something we have to live with.

But I think it is encouraging that we have increased exports over $140 billion. That indicates we have some strengths. I think, in the last year, although our abilities tend to be—certainly our vulnerabilities tend to be in automobiles, and there again we are dealing with a significant wage differential, the Japanese come to this country, produce automobiles using United States labor at more competitive rates.

And I understand in many cases they produce cars in the United States that equal the quality of what they produce in their own country.

But, take oil. The biggest chunk of our trade deficit results from the oil deficit. That is not technologically driven, as I understand it. It is commodities subject to manipulation by those outside of our control.

So I just wanted to add that comment.

I want to get back to a point which you raised on the question of United States piling up debt.

You mentioned that—which I don't disagree with—the expenditure is too much on the consumption side. But you related that to the Government operating budgets as being excessively on the consumption side.

Have you tracked Federal expenditures, say, over a period of 20 years and drawn a distinction between what you might characterize as capital investment and, in contreast, a current consumption?

And what would those trends say about what we are doing?

Mr. CHIMERINE. If you call military spending or parts of it——

Representative McMILLAN. Some probably fall clearly into that category.

Mr. CHIMERINE. Spending on the infrastructure has gone down dramatically over the last 10 to 15 years. I think everybody would agree with that, that we have neglected that.

Representative McMILLAN. During those years, we have built interstate highway systems, and we've diminished defense expenditures, and it could have been the other way.

Mr. CHIMERINE. Some of that is justified. Once we built the highway system, we didn't need that level of spending, at least to the same extent.

Some people would argue that we have cut funding for various programs in human capital, whether it's education or job retraining or whatever. One thing we knew clearly is that if you take interest and the entitlements as a share of Federal spending, they are rising quite rapidly. The rest as a share of Federal spending is falling.

And some of that would be the kind of investment we are talking about that might be needed to build for the future. It would be very difficult to measure the effectiveness of all of these programs and I don't want to overstate that.

What I'm saying, though, is that there's no evidence to suggest that most of the debt has been used to fund high levels of productive investment; whether it has fallen dramatically, we can debate, but it is clear it is not going into a higher level of investment.

Representative McMILLAN. Do you think it would be constructive for us to alter our budgeting-accounting process to draw a distinction, make a distinction between long-term commitments and short-term commitments? And make that a part of our——

Mr. CHIMERINE. It would help. And I think eventually we have to address the effectiveness of the programs. You don't have enough money to fund everything.

And that is a useful way of going about that. I think that would be productive.

Representative McMILLAN. We have been going at it for 200 years and we still have not solved the problem.

Now, on the question of foreign investment—had we discussed foreign investment?

Representative HAMILTON. Go right ahead.

Representative McMILLAN. Everyone is raising the alarm bells about the level of foreign investment in this country, and we tend to lump it all under one category.

Would any of you care to comment on whether or not you are alarmed about the level of foreign investment and draw some distinction perhaps between, let's say, our growing dependence in recent years to fund government short-term obligations through foreign investment as opposed to Federal investment in long-term capital commitments, fixed assets in this country that they can't take with them?

Mr. **Rahn**. I am all in favor of foreign investment. I like it. It creates new jobs, new technologies, new managerial skills, and increases our standard of living. We hire lots of new people because of foreign investment.

And I think the argument about foreign investment has been greatly exaggerated. The amount of assets in the United States owned by foreigners is just about 5.5 percent.

And the British are the single biggest investors. They have about 1.7 percent. They are followed by the Dutch. And the Japanese and the Canadians are about tied for third. The Dutch have almost twice the investment in the United States as the Japanese.

And when was the last time you heard anybody complain about Dutch investment in the United States?

I haven't heard many complaints about that. I usually don't hear complaints when people get jobs in new plants.

Your question about the extent of investment in portfolio versus fixed-plant investment, belies the fact that money is all fungible. Clearly, it is desirable to have investment in new plants.

It makes America healthier. And we built our railroads in the last century primarily through British investment. We then paid off the bondholders. Most of them were happy with the rate of return they received, but we had enormous advantages in this country in terms of productivity improvements because of the advances in our infrastructure. Encouraging reasonable amounts of foreign investment is something we ought to do, and we ought to be happy that the rest of the world wants to put their money in the United States.

Mr. **Sinai**. I think the flows of funds were a couple of years in U.S. financial investments and have shifted in the margin now to fairly heavy direct foreign investments.

In theory, there's nothing wrong with that, depending on how the money is used. But there are some things that happen.

No. 1 is, along with the foreign investment, the creditor position in our economy does come some ownership and control. And there is a linkage of profits to foreign investors. And that economically doesn't necessarily mean the same thing as it would mean if we were financing our own development and retaining ownership and control.

Now, I don't know over time even whether that is a bad thing, but it is different. And so, since it is part of an intense, worldwide competition for business, I guess I would be a little disturbed to see ownership and control and profits leak abroad, because some day those moneys might not flow back into the country.

And in a way, we do lose control of our own destiny in that process. Now, I think from the point of view of business, wherever the money is, that's where one wants to go and get the money. I am in business and we are seeking to get the Japanese to buy our services.

I think everybody in this country is approaching the Japanese to sell them something. But there is a price that is paid other than the interest rates, higher rates of return the foreign investors demand as they increasingly become creditors and our debt increasingly grows.

And I have no answer to whether that is a good or a bad thing. In theory, there is nothing wrong with it. In the reality of world competition and economic and political power, I suspect in the long run it is a bad thing for our country, and it disturbs me in that sense.

I have a very simple-minded view. Where the money probably goes, I would rather be a creditor than a debtor any time because economic and political power in history has always gone with those with the capital, the money capital, physical capital.

We can debate the numbers about our indebtedness but we are now on that track, and it feels good near term. It allows us to spend and do our business near term.

But, 5 or 10 years down the road, I do have some alarm about that trend.

Mr. **Chimerine**. May I make a quick answer?

My answer will somewhat parallel Allen Sinai's, but what disturbs me, first, is why that has happened.

To a great extent, it is happening because of the deterioration of our competitive position in world markets and the large trade deficits that have resulted.

I think it is really the competitive problem that is the most serious.

Second, we talked earlier about how much of that trade deficit reflects higher wages. And I agree with you, we became a high-cost country. The real essence of the problem is we no longer have the productivity advantages to justify the high-wage structure in this country.

And as productivity stopped growing, we made ourselves an easy target for the rest of the world to catch up to. The trick now is to solve the competitive problem in a way that does not lower our living standards by squeezing wages lower or pushing the dollar lower.

And to do that, I think we need higher productivity.

Third, as Allen Sinai mentioned, this money doesn't come cost free. We're going to have to service all of this debt, all of the debt that we are accumulating overseas, even if it keeps coming.

And unless we have more favorable underlying productivity trends, and more favorable economic growth in the future, the burden of servicing that debt will grow.

Representative **McMillan**. You are agreed, unless it is excessive—it is excessive as far as the Federal debt is concerned.

Mr. **Rahn**. The key is: Is the money we borrow from abroad put into productive investments here where the rate of return on investment is higher than the amount we pay for the money?

If it is, then the foreign investment is desirable. If we borrow strictly for consumption, it is undesirable. Mexico is a good example of a country that borrowed a tremendous amount of money that was used for consumption and then it was sent elsewhere around the world.

A lot of it was essentially stolen. We do not want to get into that kind of a framework. But when people want to put their money in the United States, let's take a look at the other side of the equation.

We think about why there is a demand for goods and services from the rest of the world. Why do people want to sell us things? Because they want dollars.

About the only place the dollar is worthwhile is here in the United States. And if you look at the trade deficit perhaps it is driven by the demand for dollars. When you realize that then you start thinking a different way about it.

There's also a demand for people wanting to put their money here because they think the United States is not a failing nation. They think the United States is the future, and that is the place to put their money.

Representative McMILLAN. I think there was testimony—I will not name the name, but one of the managers, of one of the international equity funds, ships money rather easily from one commitment to the other. There is some 60 percent plus invested in equities in the United States for the first time in 20 years, and they think basically values here are undervalued.

And that's equity.

And you're talking about debt. This is equity investment. So we're not like a Third world nation. It's not giving up any equity ownership. It has overloaded itself with debt.

A lot of the equity investment, I think can be healthy. I think we need to look at this thing in detail. Look for the specific vulnerabilities rather than trying to generalize on it, because we could make some significant mistakes if we overreact to it.

Thank you, Mr. Chairman.

Representative HAMILTON. Congressman Solarz.

Representative SOLARZ. Thank you very much, Mr. Chairman.

Gentlemen, as I understand it, one of the major justifications for reducing the deficit is to diminish the need to finance the deficit through what private savings we have.

We would presumably increase the resources available for investment, since they would no longer be required to finance the deficit.

But, in fact, if we were to reduce the deficit, how sure and confident can we be that the resources that now go to finance the deficit would in fact be used for investment, as distinguished from additional consumption?

Mr. Chimerine, you pointed out I think a little bit earlier that, in an effort to increase savings, we took a whole series of steps. And as far as you could determine, although they made sense in theory, in practice they resulted in a decrease of the savings rates.

So you applied that logic here. Might we not end up with a similar situation where we reduce the deficit expecting investment to go up, but somehow it doesn't result in an increase in investment?

Mr. CHIMERINE. It depends on what other policies are pursued simultaneously. For example, I think it would be imperative, as Allen Sinai mentioned earlier, for the Fed to ease as part of this, to prevent the deficit reduction actions from dramatically lowering the economy, which would probably hurt investment, at least in the short term.

It is imperative that a reduction in the deficit lead to a lower cost of capital. That would happen in the markets. Some would have to be augmented by easing the Fed.

And, fundamentally, we have to look at every policy lever we have and every action step we can take in order to make sure that we cut the deficit in an intelligent way and adopt other policies to increase the potential for more investment.

It is not only more investment. I strongly support the sliding capital gains tax proposal that some people have posed, that is, raising the capital gains on short-term gains and sliding it down dramatically for long-term gains, because we need to stimulate more productive long-term investment, not just financial transactions.

I think we have to look at a whole raft of steps that will increase the probability of bringing about that result.

Representative HAMILTON. Do you other gentlemen support that proposal?

Mr. RAHN. I support the lower capital gains tax, not that particular proposal.

Representative HAMILTON. You do not support the sliding concept?

Mr. RAHN. I do not have an objection against the sliding scale, but I would not push the short-term rate above the existing tax rates.

Mr. SINAI. I would neither support the lower nor the sliding change. I would not support either one on economic grounds, either the sliding capital gains or reduction in the capital gains tax from 28 to 15 percent.

Representative SOLARZ. Why not?

Mr. SINAI. I find in my own work that it has a very minimal effect on capital formation. It does have a substantial effect on financial transactions, but a minimal effect on capital formation.

If one wants to promote capital formation, I would suggest restoring the investment tax credit.

Mr. RAHN. I fully disagree with what Mr. Sinai has said. I have looked at this extensively over the years and it is quite clear that when you have high capital gains taxes, you drive out venture capital and you reduce revenues to government. High capital gains tax rates are highly destructive.

And also we compete worldwide on a tax basis as we do with everything else. We have the highest capital gains tax among the industrialized world.

But, I want to get back to your original question.

Representative SOLARZ. The question was: How can we be sure the reduction in deficit will result in an increase in investment?

Mr. RAHN. The answer simply is that you can't. There is little empirical evidence to prove it one way or the other. A lot of proposals for reducing the deficits are tax increases.

Now, if you have a tax increase on capital, you're taking money out of one pocket and putting it into another. Even tax increases in consumption initially in the short term come largely out of savings because people have relatively fixed consumption levels that we were talking about earlier.

And so I think it is an illusion that you can have a big tax increase which is going to result in more capital formation by bringing down the deficit.

Representative **Solarz**. Your answer to the question on how to increase investment, if I understand you correctly, it is through the changes in the Tax Code that you rattled off before that were designed to increase savings, but also investment.

Now could each of you—you seem to have this as kind of a mantra that you recite.

Mr. **Rahn**. I've been arguing for them for a long time.

Representative **Solarz**. Could you do it again?

I would appreciate the other witnesses' comments on whether they think the changes would be productive or not.

Mr. **Rahn**. First of all, the capital gains tax changes will come up before you. There are a number of legitimate ways to do it.

There are debates on how you do it. Part of it would be indexing for inflation. Another part is the risk capital component. And, clearly, you don't want to tax inflationary gains. I don't think even Allen Sinai would be in favor of that.

There is also the reduction of the double taxation of corporate dividends. Most countries among the world give partial or full release from double taxation of corporate dividends. We tend to tax interest and basic savings higher than most of our competitors.

The Japanese, the Germans, and others, for instance, have very large exclusions for savings for individuals. And you might want to have some caps on these because of wealth distribution concerns.

If we moved in this direction and made the decision between savings and consumption much more tax neutral than it is now, I would think over the longer run you would get higher levels of savings, hence, more investment capital to augment productivity.

Representative **Solarz**. You talked about tax changes that would increase incentives for savings. What about the flip side of that, say, the fact that would penalize consumption, which would presumably hurt savings indirectly?

Mr. **Rahn**. It depends on if you are using that for a substitute for existing taxation or additional levels of taxes.

If it just becomes an additional level of tax, then you diminish basic incentives in the short run and it comes out of savings, and I don't think you're any better off.

If you use it as a substitute for existing taxes, particularly in capital, you could be better off.

Representative **Solarz**. Could each of you comment on double taxation, reducing taxes on savings and lowering capital gains as a way of encouraging greater investment?

Mr. **Chimerine**. I don't think the evidence—I disagree with Dick Rahn. I don't think the evidence suggests that lowering capital gains taxes would increase revenues.

It might in the first year but, in the long term, revenues would be lower, in my judgment.

Representative **Solarz**. Would it increase investment?

Mr. **Chimerine**. One of the reasons I had proposed the sliding scale is because if you dramatically increase the capital gains tax on short-term gains, you have a real difference.

You start with 50 percent, let's say, in the first year and slide it down to 10 percent, let's say, after 5 years, that is a sizable difference. But, going from 28 to 15 percent, I don't see where you would get that much bang for the buck on investment.

And we do have to consider the implications on the deficit. It doesn't do any good to get a little bit more investment and then wind up with a greater budget deficit.

Now, the ITC. I would do it differently than in the past, when we've had a blanket 10 percent investment tax credit.

I would make the investment tax credit larger, but I would do it on a different base, where fundamentally you want to provide an incentive at the margin.

So perhaps we could give a 15- or 20-percent investment tax credit above investment of a base period. For example, if a company spent $1 million on equipment for the last 3 years on the average, make that the base and give them an incentive or credit on everything above that, because we can't afford to give it on everything. Some of the investments they will make anyway. So these are the kinds of things I would do. I don't really agree with the prescriptions that Dick Rahn made.

And one last comment.

Depending on how you raise taxes, in the long term, funding spending by raising taxes would tend to harm or reduce consumption more than investment. Doing it the way we are doing it now, in my judgment, in the long term holds investment down more than consumption.

Representative SOLARZ. He had two other suggestions: ending double taxation of dividends and reducing the tax rate on savings.

Mr. CHIMERINE. We cannot afford the former unless we find a compensating revenue increase.

Representative SOLARZ. And reducing taxes on personal savings.

Mr. CHIMERINE. I think we have done that. I think we have learned our lesson from that. I don't see what we gain from that.

Mr. SINAI. I think—to get back to your prior question. You start with reducing budget deficits that would lower the rate of capital formation unless it was offset by a Federal Reserve policy that kept the rate of growth of the economy the same.

Now, if that happened and you had a lower profile of interest rates, a lower cost of capital, then spending in this country would shift toward capital goods and away from consumption.

So I always go back—and it is the toughest problem to deal with especially now with full employment, because it is a cyclical problem, it adds to inflation—to get budget deficits down.

Now, when we go beyond that and say you can't do that, and then you ask about various tax measures, double taxation of dividends, it's a distortion in the tax system.

It is not the same in other countries. And even if there is a revenue loss, I would favor either partial reduction or the elimination of double taxation and then equalizing more the cost of debt and equity.

Representative HAMILTON. What is the revenue loss?

Mr. SINAI. Very preliminary kinds of estimates, it could be $40 to $50 billion a year.

Representative HAMILTON. Forty to fifty billion?

Mr. SINAI. It is a big number. The loss to the Government on interest deductibility is an even bigger number.

Maybe I shouldn't mention the number. [Laughter.]

Representative HAMILTON. Let's get out of the realm of theory and get into some numbers.

Mr. SINAI. It would be very difficult to do that without some offsetting——

Representative McMILLAN. You are saying, if you made the payment of dividends deductible to the corporation.

Mr. SINAI. Taxed only once.

Representative McMILLAN. That is a $40 billion cost?

Mr. RAHN. I think that's too high. But, even so, it would be over time——

Representative McMILLAN. Suppose you adjusted the corporate base rate to offset it, how much would you have to do it?

Mr. SINAI. I have to——

Representative McMILLAN. Forty billion. What is it now?

Mr. RAHN. Seventy billion dollars in corporate taxes.

Mr. CHIMERINE. You have to raise it to well over 50 percent.

Mr. RAHN. That is the static view of the world. You would send some corporations off to other countries.

Mr. SINAI. If you're worried about the revenue loss—now, in theory, we have a problem. There are differential costs. The cost that you know of debt is far more useful taxwise than the cost of equity. And that is a distortation in the system.

I think most all economists would say to eliminate the double taxation of dividends. You need to raise the reveneus somehow and offset the revenue lost. Do it partially, but move in that direction. It is very complicated, very difficult.

And I remember working through this some 8 or 9 years ago and testifying down here on that subject, and it never happened. But we all think it should.

Capital gains tax reduction, I did comment on that. Only one additional comment——

Mr. RAHN. Would you go on with the indexing?

Mr. SINAI. Yes. The capital gains tax reduction. We did get a good-sized revenue increase off of capital gains tax reductions in prior reductions. But we had large unlocking effects on capital gains.

And from the research on the subject, I don't think anyone can conclude that we will get a revenue gain any more. We had big revenue gains in the past.

Capital gains are a small part of the cost of capital. Bigger parts of the cost of capital, I think, are things other than the capital gains tax change.

You asked about how to get consumption down. A sales tax, tax on consumption, is the value-added tax.

The problem I have is that it is too big of a revenue raiser that sets in a framework that can allow the Federal Government to raise a lot of revenue if it wants and then the Federal Government has a tendency not to be as efficient with public funds as we might like.

So that, to me, is just an open door to getting more money into the Federal Government and that is dangerous.

The gasoline tax increase is a consumption tax, and a modest one. It makes a lot of sense for deficit reduction, for cutting down all imports, for conserving on energy.

Its negative is that it is regressive, but one could take care of that in terms of providing credit to low-income families if one imposed a gasoline tax.

So that would help you in getting consumption down, a gasoline tax. And, it would be modest. It wouldn't have the negative because there is this big basket that can bring in huge amounts of revenue, when the Government decides it wants money for some reason.

Mr. CHIMERINE. Can I make two final comments?

First, any of these things are potential sources of revenue. They would augment the approach that we are talking about, for example. And I realize that this is politically difficult, but scaling back the mortgage interest reduction, you know, perhaps after a cap, you know, for a $150,000 to $200,000 house. After that, everybody can pay for financing their own interest if they want to buy a bigger house. Or perhaps reducing the interest reduction on financial transactions in the corporate sector.

And I think these are things that have to be looked at because these are the kinds of things that would have the least negative effect on productive investment, in my judgment.

Second, we have made the tax structure in this country far less progressive over the last 7 or 8 years. And I think we have to be careful about moving any further in that direction, particularly with the large increase in Social Security taxes that is now in place.

And I would strongly suggest that any tax increase now be oriented toward cutting consumption, but not be designed in a way that makes the system more risky.

Representative HAMILTON. Let me try to cover a lot of ground here in a short time. We have had a good discussion.

Maybe I can ask you to try to keep your answers relatively brief to some of these questions, and that might be helpful.

We have an administration forecast in front of us, 3.5-percent growth, and a 200-basis point decline in interest rates.

Should the Congress accept that as a way to prepare for the 1990 budget?

Mr. CHIMERINE. No. In my judgment, it is too risky and it produces an understatement of the deficits.

Representative HAMILTON. Any dissent from that?

Mr. RAHN. Yes. I think it is an in accurate forecast. I go back to the forecasting history of recent years. If you look at the forecast of the folks in the past, you will find the CEA the last 6 years tends to be less inaccurate, and they have been, if anything, on the pessimistic side rather than the optimistic side.

Representative HAMILTON. You accept the 3.5-percent growth.

Mr. RAHN. No, we lower it from 3.8 percent for 1988.

Representative HAMILTON. A decline in interest rates is a reasonable kind of an assumption?

Mr. RAHN. Yes. They view it the way we do at the chamber. What you saw with the inflation in the first part of 1988 was that it basically was induced by rapid monetary growth we had in 1986.

You have long lapses between changes in monetary growth and changes in the rate of inflation.

The Federal Reserve greatly reduced the growth rate of money supply beginning in early 1987, and that is going to be reflected in lower growth rates in inflation.

Representative **Hamilton**. You expect interest rates to come down?

Mr. **Rahn**. Yes.

Mr. **Sinai**. I think, regardless of the numbers you pick, there is an inconsistency and contradiction in the assumptions.

Now, economic growth, while in excess of 3 percent, going out 3 or 4 or 5 years, is inconsistent with declining inflation rates if the potential rate of growth is 2.5 percent, and that, in turn, is inconsistent with the decline in interest rates.

Now, for the next year or two, if the Federal Reserve is targeting the economy at 2.5 percent or so, then how can interest rates go down if the economy goes over 3 percent, which is the administration forecast?

Representative **Hamilton**. Is that a good target for the Fed?

Mr. **Sinai**. My guess is they will relax it a little because there is a clash built into what the Fed desires and what the administration is forecasting.

So they would probably let it slip. They could let it slip to 2¾ percent.

I don't see how the Federal Reserve can accept 3 percent plus growth.

Representative **Hamilton**. Is it possible to use monetary policy to keep the economy growing at a 2.5-percent, 3-percent rate over the long-run?

Mr. **Sinai**. Sure. You have to get higher interest rates to do that. The other way—what I would say——

Representative **Hamilton**. If you get 3-percent growth, 3.5-percent growth, would you get a resurgence of inflation?

Mr. **Sinai**. We will get 5 percent inflation almost no matter what, mainly because of oil and energy price rises.

Representative **Hamilton**. You think you can get 3.5 percent growth without a resurgence of inflation?

Mr. **Rahn**. Clearly. I can go back to 1980. Everybody told us we could not bring down inflation. We could not increase employment growth, that it was impossible.

And, after listening to the pessimism and how year after year so many of the forecasters said the recession is a year off, that we couldn't continue to do as well as we had, I said: "Go back and look at the history from 1980. Who was right and who was wrong?"

I disagree with the notion the economy cannot grow faster.

Representative **Hamilton**. Do any see early warning signs of a recession?

Mr. **Sinai**. It is not a question of who is right or who is wrong. The question before you is, how you plan. And all I'm saying is the growth rates and the inflation rates and the interest rates are inconsistent.

The only way you can get that result is to lower oil prices. You can also get it through a supply-side kick on productivity.

Representative **Hamilton**. Can the current expansion go on indefinitely?

Mr. Rahn said in his testimony, if I recall right, that you have to have a policy mistake to bring about recession.

Mr. **Rahn**. If you had a massive California earthquake or extremely bad weather that could hurt the economy. Historically, it has not only been a mistake on the part of the Fed, but other government policy as well.

Representative **Hamilton**. That suggests there isn't any such thing, or does it suggest that there's no such thing, as a natural business cycle that operates?

Mr. **Rahn**. Not in the old, sort of agricultural sense of the 19th century economists. I think we have gone well beyond that. We will make mistakes over time and I expect at some point, we indeed would have a recession, but I also think it would come now from a policy mistake, not because of something inherently built into the economy.

Mr. **Chimerine**. May I answer that, Mr. Chairman?

I think that there are two separate, somewhat related but somewhat different questions.

One is are we going to have a recession?

And the second one is what is the likely rate of average economic growth over the next, let's say, 5 years, which corresponds to the latest administration forecast.

Theoretically, you can go 20 years without a recession, but still have average economic growth 1 percent or 2 percent. That would be below what it has been historically, even though we had frequent recessions historically.

What I am saying, what I hear Allen Sinai saying, is that when you look at the underlying fundamentals of productivity, the fact we have used up the considerable slack that existed at the beginning of the expansion, the reduced pent-up demand, and all of the other factors, the most prudent assumption to make is that average economic growth over the next 5 years is going to fall sharply below what it has been in the last 6 years, whether there is a recession or not.

I'm not even sure that is relevant for what assumptions you use.

Representative **Hamilton**. When do you think the next recession will be?

Mr. **Chimerine**. My best guess: 1991. But it is a guess.

Representative **Hamilton**. Mr. Sinai.

Mr. **Sinai**. I said in my opening statement: 1990.

Representative **Hamilton**. Mr. Rahn.

Mr. **Rahn**. I won't even try to forecast more than 2 years out. And I don't see one coming. It would be throwing darts to try to do more.

Mr. **Sinai**. The recessions we have had have not just come about because of the Federal Reserve. The Federal Reserve in every situation has responded to an undesirably high rate of inflation.

Mr. **Rahn**. But the onset of the accelerating rate of the inflation, Mr. Sinai, didn't come from sun spots.

Mr. **Sinai**. Did that cause the inflation in the late seventies?

Mr. **Rahn**. Excessive monetary growth caused it.

Mr. **Sinai**. Other forces had nothing to do with it? Oil prices had nothing to do with it?

Mr. **Rahn**. No.

Representative **Hamilton**. I'm trying to get the opinions out here on the table. [Laughter.] I'm getting them a little faster than I want.

Mr. **Sinai**. You ask the questions fast, we'll give you fast answers.

Representative **Hamilton**. That's fine. That's what I asked you to do.

How close is the unemployment rate to full employment?

Mr. **Sinai**. Our estimate is 5 percent, and the full employment-unemployment rate—it is designated as the zone of full employment because inflation begins to accelerate at around 5.5 percent. That's when it began to pick up this time.

Now, if you asked in this episode what is the full employment-unemployment rate, our estimate would be 4 to 5 percent or 5.1 percent. You did get a pickup in inflation before you reached that; it started at 5.5 percent this time.

Mr. **Chimerine**. I would say it is lower, Mr. Chairman, because I think there has been a major change in the wage setting process in this country.

The point is whatever it is we are getting fairly close; whereas, 5 years ago, we were 6 percentage points away from it.

Mr. **Rahn**. I disagree with this, too. I went back and read everybody's testimony in the spring of 1981, when the Reagan program was first proposed. It was virtually unanimous agreement of the traditional Keynesian economic establishment: full employment was somewhere between 6 to 6.5 percent, converging around 6.3 percent.

But, thinking back to the mid-1960's, we had unemployment rates at low as 3.6 percent without a big rise in inflation.

I think it really depends on how rapidly you approach it. You can continue to bring down unemployment rates slowly, month after month.

If you suddenly try to drop down to 3.6 percent in a 6-month period, I don't think you can do that without a side effect of big inflation.

But, if you ask me, can we continue to reduce unemployment rates on an average of approximately one-tenth of a percent per month or 1 full percent per year for a couple of more years, I would say yes.

Representative **Hamilton**. Do you think the policy that the Fed is following now, pushing interest rates up and trying to slow the economy, is the correct thing to be doing now?

Mr. **Chimerine**. I don't think interest rates are going up only because of the Fed. I think some of it reflects market forces, including the weaker dollar, until the last month or two.

And the Fed, to some extent, is just following along. If you look at measures on the availability of credit——

Representative **Hamilton**. You think the Fed is trying to slow the economy?

Mr. **Chimerine**. Yes. They're trying to slow it a little bit, but I don't think anybody——

Representative **Hamilton**. Is that a good thing to do?

Mr. **Chimerine**. Mr. Rahn.

Mr. **Rahn**. I think the majority of the members of the Federal Reserve Board think that they have set the rate of interest, at least in my conversations with them. I think they overreact to the debt. I don't think we needed the latest discount rise that we had. And I think you will see an easing off on interest rates.

Mr. **Sinai**. I think the Fed is doing all that it can do, taking the appropriate action, under the conditions that they are faced with; the inflation is too high. Although most people in this country do not worry about 4.5 percent inflation, internationally, it is too high.

Second, if interest rates are raised too sharply to get the inflation rate down fast, the dollar goes up and that creates problems in the external deficit. In theory, we have a whopping huge fiscal deficit, which constrains the Fed as well and does not permit them to follow as easy a monetary policy as they might otherwise.

Given the circumstances, they have no choice. By process of elimination.

Representative **Hamilton**. Adjusting the interest rates like they do, is that what you call finetuning?

Mr. **Rahn**. Yes.

Representative **Hamilton**. Is that good?

Mr. **Rahn**. No. We also have the problem of an inverted yield curve in late December. And that clearly showed the Fed was too tight at that time.

Representative **Hamilton**. I don't think I have anything further.

Representative **McMillan**. I would conclude with this. One of the objectives of this committee is to try to develop information so that Congress can make an intelligent decision. [Laughter.] We ask you all these questions and we get all of this dissent coming back—two yeses, one no, and two noes and one yes.

I would recall a little bit of history, and I'm not really picking at you, but a year ago, Blue Chip took a survey of 52 major forecasting firms and the range of forecast was from a low of minus 1.3 to a high of plus 3.7 percent in GNP with an average of 2.2 percent.

Last week, Commerce called the report at 3.8 percent for the period in question. And I think you, Mr. Sinai, have been before this committee last year and made a forecast of between 2 to 2.5 percent. And the WEFA group forecast 2.3 percent in the 1980 issue of Blue Chip; U.S. Chamber forecasted 2.6 percent against the 3.8 percent.

And I'm sure you all are happy that we ended up with the 3.8 percent.

But, what occurred that you didn't anticipate?

Anything outstanding?

Mr. **Sinai**. I think the anticipated effect of the crash of the stock market made most forecasters think it would not rise very much. And the lesson is that the economy is more insulated from the stock market than one might think.

So, as long as job growth was good, income growth was good and the Federal Reserve engineered lower interest rates, the economy very quickly got back on its trajectory.

My own forecast at that time, about 1 month later, I was back to about 3 percent, which had been the precrash forecast.

And I thought it would slow down a lot more for that reason, and it didn't. And in looking back, these are the reasons why I think it did not slow down.

I think also we have all underestimated—I tended to be pretty optimistic on growth for a long time, but I think we have all underestimated—and that is always what happens when you have the strong upswing—and downswing. And then the downswing is underestimated. It is the nature of forecasting. So much averaging goes on in the methods, in the way that forecasters do what they do.

And you ought to be aware of that when you listen to people like us in what we say. Understand there is a lot of averaging that goes into the process.

Representative **McMillan**. We are more aware of that. Sometimes, we wonder what the forecasts are. But they come across with a little more certainty sometimes than maybe you express in retrospect.

Mr. **Rahn**. That's a point I was trying to make at the beginning of my testimony, is that you look at the—the last 6 years, at the census. At least 4 out of the 6 years have been considerably under what actually happened. And, on average, it has been considerably under what happened.

And the pessimists I think have been rather consistently wrong. And even though we have been considered at the optimistic end of the scale, we have underestimated. And, hence, I would hope that the committee would not take any forecast with great certainties.

There are certain things in policies that we know are undesirable or desirable, and that's where you ought to focus, not on what the short-term forecasts necessarily are.

Representative **Hamilton**. Let me ask a question with regard to investment: Would a lower capital gains tax or a lower Federal deficit be better for business investment?

Mr. **Rahn**. A lower capital gains tax rate would be better. But a rate reduction would increase revenues, so I will not accept the premise of the question.

Mr. **Chimerine**. I would give an opposite answer.

Mr. **Sinai**. In that choice, exactly what you said. I would say capital gains tax rate reduction because reducing the Federal budget deficit takes demand out of the economy, reduces sales, and reduces profits. And that reduces investment by more.

Mr. **Chimerine**. May I make one comment on that?

I think what you are talking about, Mr. Chairman, is a slow, gradual reduction in the budget deficit over time.

Representative **Hamilton**. Let me ask about deficit reduction. Getting away from Gramm-Rudman, away from everything else for a minute and just think in terms of what is the right path for fiscal policy in getting the deficit down, from $150 billion or whatever it is?

And I presume you would not want to drop it down to zero in 1 year.

What is your path? Should we attain $40/$50 billion per year, $20/$30 or what?

Mr. **Chimerine**. I would try to do something like——

Representative HAMILTON. Should we aim for a surplus and, if so, how quickly?

Mr. CHIMERINE. The first step is to get it as close to balanced as you can using reasonable economic assumptions. Not depending on the assumptions to do the job for you. Reducing it by something in the range of $30 billion a year for the last 5 years would be acceptable.

Representative HAMILTON. We're not talking about how you do that. I just want to get the flat path.

Mr. RAHN. You have the Gramm-Rudman targets in effect. They are reasonably good approximations. And I would try to get it down.

Mr. SINAI. $20 billion, $30 billion, $40 billion. Don't try to get the full budget deficit in balance. Get the structural deficit in balance.

Representative HAMILTON. And, finally, just a question on——

Representative McMILLAN. You also asked did you think we should begin to generate the surplus.

Representative HAMILTON. Does anybody feel—I think they feel it is outside the realm of possibility. [Laughter.]

Mr. SINAI. Yes, but one step at a time.

Representative HAMILTON. Let me ask a general question.

You all deal with Federal economic statistics, frequently. What is your impression? Are they getting better? Getting worse?

Mr. CHIMERINE. Yes. Yes, they're getting worse. I think, Mr. Chairman, that the monthly numbers have become less reliable over the last 5 years, partly reflecting changes in the economy that are not being reflected in the data-gathering procedures. Part of it is that we have had budget cuts in the statistical agencies.

I may be overexaggerating that because I feel that we tend to overanalyze. We read things that are not in there, but are really just erratic movements. But, if you asked me the question directly, my feeling is there is somewhat less reliability in the monthly statistics now than 5 or 10 years ago.

Mr. RAHN. You may have to get a consensus on this answer, but I agree with everything that Larry Chimerine said.

Mr. CHIMERINE. I will change my answer. [Laughter.]

Mr. RAHN. It is indeed an increasing problem. We look at the revisions and the error ranges. I'm not sure we are collecting the right set of statistics any longer for the economy. I think we need to do some fundamental rethinking, and that is one area, as much as I am reluctant to put more money into government, that I think it might be profitable, well spent, to put more money into.

Representative HAMILTON. We may want to revise this issue.

Mr. SINAI. How can I not prevent a consensus?

Representative HAMILTON. It took us all morning to find a consensus.

Mr. SINAI. I don't think it makes much difference. It doesn't amount to a hill of beans that they're slightly worse. I don't think it will matter much one way or the other.

Mr. CHIMERINE. I think the international aspect is a big problem there. We do not measure that well.

Mr. RAHN. The trade statistics are terrible.

Representative **Hamilton**. All right, gentlemen. We have had a good discussion. We appreciate it very much, and we stand adjourned.

[Whereupon, at 12:16 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1989 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 9, 1989

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2218, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Obey, and Upton.

Also present: Joseph J. Minarik, executive director; Robert J. Tosterud, minority assistant director; and William Buechner, Dale Jahr, Jim Klumpner, Dayna Hutchings, and Ken Nelson, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, PRESIDING

Representative Obey [presiding]. Well, I suppose we ought to begin. First of all let me explain, my name is not Congressman Lee Hamilton. The chairman had to go down to the White House and so he asked me to stand in.

It reminds me, when I was in the State legislature Governor Reynolds was supposed to appear before an American Legion convention, and at the last minute he couldn't do it, and he called me and asked if I would appear instead. So I did, and when I was introduced they said, "We had originally expected to have the Governor with us. He can't be here, and so it's with a great deal of regret that we give you State Senator Obey." [Laughter.] So let me simply say that today the Joint Economic Committee resumes hearings on the economic outlook for 1989 and the 1989 Economic Report of the President. The focus on this morning's hearing will be on U.S. international trade and international economic relations.

There are a number of issues the committee expects to cover during the hearing, including the outlook for U.S. trade balance and trade policies in the United States and abroad, the current conduct of monetary policy and exchange rate policy; U.S. policies toward Third World debt; and the impact of economic conditions and economic policies in Europe, Japan, and the rest of the world on the U.S. economic outlook.

The committee is very pleased this morning to have three highly regarded economists testifying: Mr. David D. Hale, chief economist, Kemper Financial Services; Mr. Jeffrey Sachs, professor of economics, Harvard University; and Mr. John Williamson, senior fellow, Institute for International Economics.

Before we turn to the witnesses, I understand Congressman Upton had something he wanted to say.

OPENING STATEMENT OF REPRESENTATIVE UPTON

Representative UPTON. Thank you, Mr. Chairman.

This morning's hearing is my first as a member of the Joint Economic Committee. Since its creation in the 1940's, the JEC has performed a valuable role in exploring some of the large ideas and actions in the economic arena. I very much look forward to working with my colleagues and with the staff of the JEC on these issues in the future.

The JEC has the flexibility to focus on many emerging economic challenges and opportunities. I'm encouraging by the direction of Chairman Hamilton's announced intent to focus on economic growth and fairness in our economy, looking at where the United States should be in the next 5 years.

While I no doubt will have some differences with the chairman on particular approaches, the principle of fairness is precisely the approach that Congress should take, to address America's enormous budget and economic problems. In particular, I hope to use my service on the JEC to emphasize that increasing taxes is not the answer to our budget and other economic problems.

As part of this committee's annual hearings on the economic outlook, today's focus on international trade is timely. As a Congressman from Michigan, my constitutents are going to be particularly affected by the recently concluded United States-Canadian Free Trade Agreement. I intend to devote considerable time to monitoring this agreement over the next few years.

In addition to the Free Trade Agreement, by virtually every action we take, the United States dramatically increases its involvement in the global economy. Today there are few, if any, areas of the domestic U.S. economy which remains untouched by the global economy, from corner grocery stores, farmers, to large corporations.

I look forward this morning to my first hearing with the committee and to hear from our witnesses.

Representative OBEY. Thank you.

Mr. Hale, why don't we begin with you? Why don't each of you just assume your prepared statements will be inserted in the record and take 10 to 15 minutes to say whatever it is you'd like to say, just so we understand it.

STATEMENT OF DAVID D. HALE, CHIEF ECONOMIST, KEMPER FINANCIAL SERVICES, INC.

Mr. HALE. Thank you very much, Congressman Obey.

I would like to devote my testimony to two major topics: First, the U.S. trade outlook; and, second, the collapse in America's share of world stock market capitalization during the 1980's and some of its potential implications for our economic policy and other countries' economic policies during the next few years.

First let me turn back to the trade outlook, though; 1988 was a year of significant improvement for the U.S. trade deficit. While all the data are not yet in, it appears that our trade deficit dropped from $159 billion in 1987 to about $125 to $130 billion in the year just ended.

This improvement reflected a variety of developments. First, the lagged benefits on our export competitiveness of the big dollar devaluation which occurred in 1985, 1986, and 1987; and, second, the significant improvement in the relative growth rates of many of the other major industrial nations.

In Japan last year domestic demand grew by over 7 percent; in Britain it grew by almost 6 percent; in Germany by 4 percent; and in the rest of Europe, broadly speaking, by 3½ to 4 percent as well. In addition, we've seen significant growth in domestic demand from many of the newly industrializing countries of East Asia, and this should continue in the year ahead.

In fact, the great liquidity bubble in the economies of East Asia, produced by their big trade surpluses, is now working its way fully through their economies. In 1986 and 1987 we had stock market booms. Last year we had property booms. And this year we're going to have significant wage inflation in those countries. By the end of this year, the rate of growth in wages will be 10 to 15 percent in Taiwan, Korea, and Hong Kong.

It is quite possible that all of those economies will be experiencing double-digit inflation as well. That would imply a significant rise in their demand for imports and now, because of this growing wage pressure, a movement of their industry to countries to the south, such as the Philippines, Indonesia, and South China, which in turn will make those economies more important players in the world system over the next 2 or 3 years.

The major missing element in the global expansion we have seen during the last 18 months is the countries to our south: Latin America. Since we have Jeff Sachs here, who is a recognized expert in the field, I will not spend a great deal of time on Latin America.

The point is we did have a significant improvement in the international environment for our exports last year, and were able to take advantage of it in a variety of industries.

I think trade improvement will continue in 1989. We'll see a further $10 or $20 billion improvement in our trade account. But I am concerned that by the middle of the year or by the autumn of 1989, the trade adjustment process could begin to stall for two reasons:

First, America itself is a country that's running low on manufacturing capacity. We have a significant rise in utilization rates. Capital spending is improving, but many industries are now operating at close to the ceilings for what would be considered effective but not inflationary capacity. That is, to get further capacity going might require price increases that would be perceived as inflationary and undesirable for our economy.

Second, from a longer term macroeconomic point of view, our overall domestic savings and investment balance is not yet consistent with a current account deficit below 2½ perclent of GNP over the next 2 or 3 years. I discuss this in great detail in my prepared statement. Let me just summarize briefly what the issues are here.

Broadly, America needs an economic policy over the next 2 or 3 years which will permit us to expand by about 2½ to 3 percent, a level which the Federal Reserve and most private economists believe is our optimal noninflationary growth rate. They arrive at that level by adding productivity growth of about 1.1 percent per annum, to labor force growth of about 1.5 percent. We must in turn almost divert some portion of that output growth—0.7, 0.8 percent per annum—to reducing our trade deficit.

The microcomponents of this macroadjustment process, meanwhile, must be consistent with maintaining our private savings rate, actually over time raising our private savings rate, while also maintaining a high enough level of business investment to improve our manufacturing capital stock in order to create more capacity for generating exports and import substitution during the 1990's.

The danger we face is that if we don't get a policy mix that has these broad macroparameters with microcomponents consistent with a high level of private savings and investment, we will be faced with higher inflation over the next 2 or 3 years as we overtax our supply of resources. The Federal Reserve will have to assume the primary responsibility for keeping demand under control. That would mean higher interest rates. And higher interest rates in the current international financial environment, with large pools of short-term money chasing yield differentials, would mean a further rise in the dollar real exchange rate that would in turn slow down our export process.

In short, we could have a minireplay of what happened in the first half of the 1980's. Not a huge dollar rally—60 percent like we had during that period—but a dollar rally that would go far enough in the context of our already-existing inflation range of 4 to 5 percent, to damage our export competitiveness and stall the global trade adjustment process in late 1989 and in 1990.

Unfortunately, for us to have a further significant improvement in our trade account, there has to be a change in our domestic macromix, centering on the budget deficit as well as enhancing our private savings rate. I realize this is a very old and very tired issue. One hates to dwell on it because so much has already been said about it, but the fact is our trade account is an accounting residual of our domestic savings and investment balance, and we cannot hope to have major progress there if we don't deal with the fiscal deficit.

And I would add that the very economic assumptions underpinning the new 1990 budget would themselves be called into question if we don't get adequate fiscal action.

For example, the new economic forecast that came out a few weeks ago is projecting a 5.7 percent Treasury bill in 1990. In my opinion we can only achieve that Treasury bill yield if we decide to start borrowing in yen rather than dollars or, in fact, have a significant change in our budget policy to take pressure off the domestic financial markets.

In short, we need compliance with Gramm-Rudman if we're going to have significant progress on the trade front beyond 1989.

Let me now switch over to the issue of world stock market capitalization. As you will see in my prepared statement, I devoted a great deal of attention to this topic because I think it is a very important indicator that we can use in gauging the economic policies of the 1980's and their impact both on the United States and world economy.

We have had during recent years significant discussion about America's reemergence as an external debtor nation. In my opinion, that topic has been vastly exaggerated. It doesn't matter really to a country's economic performance whether it's a debtor or creditor. What matters is what you do with the money. What matters is what happens to your investment share of GNP and the kind of economic performance you get from that.

I regard the change in world stock market capitalization during recent years as significant because it gives us a provisional market verdict on what's happened.

First let me just state what has happened to world stock market capitalization. In 1980 the U.S. stock market accounted for about 55 percent of world stock market capitalization. It's now down to about 28 percent. There has been some growth in the share owned by Europe, but the dominant change has been a huge rise in Japan's share—17 percent to about 45 percent a few weeks ago.

I think that this change has two major implications, two major consequences. First, it tells us that investors both in this country and globally are unwilling to put a high valuation on U.S. assets as measured by our stock market, because they fear that the final consequences of the policy mix we have could evolve in a very adverse way for savings and investment and thus for our economic performance.

That is, investors are demanding a very big risk premium for owning U.S. assets because they are afraid the prosperity we've had is falsely based and could fall apart at some time in the next 2 or 3 years if we don't get the correct mixture of policies to close our budget deficit and close our trade deficit without depressing private saving and investment.

Second, I think it's also important to reflect on the fact that the major beneficiary of the drop in our share of world stock market capitalization has been Japan. This large rise in Japan's share of world stock market capitalization reflects three factors, two macroeconomic, and one microeceonomic.

The two macroeconomic variables are traditional ones that drive stock markets: tremendous expansion in Japanese liquidity because of big current account surpluses and a high savings rate; second, a large rise in Japan's profits because of the success of Japanese industry in coping with a variety of economic environments during this decade-first a weak yen, then a strong yen; first export-led growth; more recently a boom in domestic consumption, as well as a restructuring of the Japanese economy to move a great deal of production offshore.

The third factor, the one I'd like to finish up on here for 2 minutes is also very important, and that is the emergence of the Japanese stock market in recent years as an informal instrument of government economic policy for enhancing Japan's economic restructuring as well as for powering the growth of Japanese financial institutions in the world economy as a whole.

During the postwar period, the Tokyo stock market has not played a major role in Japan's economic development. Japan was a country that until recently was primarily financed by bank lending. But during the last 3 or 4 years, the stock market has become a significant force in the recapitalization of the Japanese industrial sector and the banking system.

Last year, for example, equity capital formation in Japan was equal to almost 5 percent of GNP, $120 billion through a combination of share flotations as well as convertible equity financing. This consisted primarily of three things: privatization of government-owned industries like the telephone company and a state airline; second, a significant recapitalization of the banking sector; and, third, the restructuring of various older industries, such as steel which are now redeploying assets to get ready for a new international economic environment during the 1990's in which they will become more than just steel companies. They will be involved in other industries, reflecting the changes in Japan's place in the world, no longer just an export-led nation but also a country with a large domestic economy.

I think that it is important for us to look at these changes in the role of the Japanese stock market, because in contrast to this country, in contrast to the United States, the Japanese Government has been a major player. It has given the market official support in a variety of ways in order to enhance its role as a source of capital and to improve the competitive position of Japanese financial institutions on the world stage.

How does the Japanese Government influence the stock market? In a variety of ways. First, the government tolerates very large cross-shareholdings. Almost half the stock in Japan is tied up in corporate cross-shareholdings which limits the marketability of stock and enhances the ability of firms and brokers to guide share prices.

Second, there has been very little antitrust in the Japanese stock market. Four brokers control over half of all trading activity. One, Nomura, controls almost a quarter of it. These firms also operate with fixed commissions, giving them large guaranteed returns they can use for again guiding share prices during periods of stress.

Third, the government has shown itself to be a very active player in the management of accounting regulations, more recently in using moral suasion over the future markets, and taking other actions to show that it favors rising market share in order to enhance Japan's economic place in the world.

These are not new developments. They've gone on for many years. But they have become important, I think, to the outside world today because Japan no longer accounts for 5 or 10 percent of world stock market capitalization; it now accounts for about 45 percent, while its GNP is about 20 to 21 percent of the world total compared to, again, 5 or 10 percent at the beginning of this decade.

Again, this is a very complex topic, not one we can spend a lot of time on here today, but I would encourage the committee to do some follow-on research in the next year on the issue of how American financial institutions and corporations will be able to compete with a country in which the government plays an active role in guiding the stock market, and thus significantly alters the price at which capital is raised. What are the implications of a Tokyo market for U.S. competitiveness, financial regulation, and trade policy?

Thank you.

[The prepared statement of Mr. Hale follows:]

PREPARED STATEMENT OF DAVID D. HALE

SUMMARY

This testimony is in two parts. Section One reviews the U.S. trade outlook for the next few years and concludes that it will be impossible to bring the current account deficit below $100 billion unless there is a major reduction in the federal deficit or a dramatic change in private savings behavior. Without a change in federal fiscal policy, the Federal Reserve will have to assume primary responsibility for restraining inflation by increasing interest rates and permitting the dollar to rise to levels which will dampen U.S. export growth. Section two examines the changing nature of the U.S.-Japan relationship and its implications for both macroeconomic and microeconomic policy. While Japan has played a very constructive macroeconomic role in the world economy during the past two years, the immense growth in her financial power will pose new competitive challenges to the United States. One aspect of that challenge which now deserves more attention is the role played by the Tokyo stock market in funding the global expansion of Japanese financial institutions. Since 1980, the Tokyo stock market has grown from 17% of total world stock market capitalization to 46% while the U.S. share has shrunk from 55% to 27%. Much of the rise in the Tokyo market reflects traditional economic factors, such as liquidity and profits, but some of it also stems from institutional differences, including government supervision, which render the Tokyo market less vulnerable to shocks than stock markets in other countries. Because of the Tokyo stock market's emergence as an important engine of Japanese global expansion, it is important for policy makers in other countries to rethink how their own financial institutions will be able to remain competitive with Japan's during the 1990's.

The U.S. Trade Outlook

The U.S. economy has begun a balance of payments adjustment process which is likely to extend over many years. In 1988, the trade deficit appears to have fallen to about $125-130 billion from $158 billion in 1987. Because of deterioration in the country's external investment position, the current account deficit probably remained above $130 billion but it did decline both in absolute terms from a 1987 level of $155 billion and as a share of GNP from 3.5% to 2.8%.

Several factors supported the improvement in the U.S. trade account during 1988. The growth rate of real non-farm exports accelerated to 23% in 1988 from 15% in 1987 while the growth rate of non-oil imports slowed to 5.5% from 7.1% in 1987. This change in the relative growth rates of exports and imports resulted from the lagged effects of the 1985-1987 dollar devaluation on price competitiveness as well as strong growth of domestic spending in many foreign markets. In 1988, for example, domestic demand grew by 7.5% in Japan, 6% in Britain, 4.0% in Germany, and 3.5% in France compared to about 2.8% in the United States. Such healthy growth in the big foreign economies, coupled with continuing robust economic growth rates in East Asia, helped to produce strong demand for U.S. exports.

The danger facing the world economy in 1989 is that the balance of adjustment process could grind to a halt because of the persistence of large fiscal deficits in the United States, a shortage of U.S. manufacturing capacity for producing more exports, and slower growth in many foreign economies. In fact, recent trade data suggest that the first two of these factors may already be stabilizing the trade deficit in the $120-140 billion range. During the past two quarters, there has been a sharp slowing in the growth rate of exports while imports have begun to recover. As a result, the Commerce Department's measure of the real manufacturing trade deficit has been static for three consecutive quarters after improving by an amount equal to nearly 1% of GNP during the four previous quarters.

There appear to be both physical and financial constraints on further rapid improvement of the trade deficit. Once an economy achieves full resource utilization, its optimal non-inflationary growth rate consists of labor force growth and productivity growth. In the U.S., the labor force is expanding by 1.5% per annum and productivity by about 1.1% per annum. Hence, the economy's potential non-inflationary growth rate is 2.6%. During 1988, real final sales expanded by over 3.6% at annual rates because domestic spending grew at a 2.8% annual rate while the trade deficit shrank at a rate equal to 0.8% of GNP per annum. With U.S. resource demand starting to outstrip potential supply, the Fed has permitted short-term interest rates to increase. The rise in American yields has encouraged dollar appreciation by increasing the relative attractiveness of U.S. financial assets. Nor are the resource constraints pushing up U.S. interest rates and the dollar solely limited to the labor market and manufacturing capacity; they are financial as well. However competitive American industry may be in price terms, the nation's external deficit is an accounting by-product of a domestic savings and investment imbalance which will not permit it to shrink below $120 billion during the next three years without a major change in either U.S. fiscal policy or private savings.

A few numbers illustrate why. In 1987, the U.S. had a gross private savings rate of 14.7% of GNP, a public sector deficit of 2.2% of GNP, and a private investment rate of 15.8% of GNP. The difference between the net national savings rate of 12.5% (private savings less the government deficit) and the investment rate of 15.8% was a current account deficit equal to 3.5% of GNP and a statistical discrepancy of 0.2% of GNP. If the current account deficit is to fall sharply from that level, the U.S. cannot merely devalue the dollar in order to encourage faster exports; there also has to be a change in domestic savings and investment to reduce the country's need for external capital.

On the basis of existing fiscal policies, one can make a case for the current account deficit to drop to about 2.3% of GNP ($130-135 billion) by 1990, but no further. Two factors are likely to increase the national savings rate during the next few years. The growth of the social security trust fund will probably hold the federal deficit at 3.0% of GNP through 1990 even if the economy slows (the deficit would be 4.0% in the absence of the surplus). Slower price appreciation of financial assets and real estate during 1989 and 1990 than occured during the mid-1980's will probably also encourage the household sector to increase its savings rate by .3 - .5% of GNP. But the improved outlook for the government deficit and personal savings will be partly offset by negative savings trends in the corporate sector. The retained corporate cash flow share of GNP (depreciation and retained earnings) will probably be only 11.7% in 1990 compared to 13% in 1986 because of the adverse effects of tax reform on depreciation allowances and rising wages on corporate profitability. It is true that manufacturing profits have boomed during the past year, but, unfortunately, the economic policies which prevailed during the first half of the decade reduced the manufacturing share of corporate profits from a post-war average of nearly 45% to 33% in 1985. As a result, much of today's profit boom in manufacturing is simply an income transfer from a bloated retail industry, not a rise in total corporate savings. Meanwhile, the investment share of GNP must rise in order to offset the erosion which occurred in the nation's manufacturing capital stock during the first half of the 1980's. These divergent forces suggest that net private savings will rise to 13.2% of GNP by 1990 while gross private domestic investment will ease to 15.5%. Such numbers would permit the current account deficit to contract to only 2.3% of GNP, or about $130-135 billion.

There are two possible paths by which the dollar's real exchange rate can appreciate to sustain a large trade deficit for balancing domestic savings and investment; the dollar's nominal value can rise or the domestic inflation rate can accelerate relative to inflation in other countries while the nominal exchange rate remains unchanged. In the first half of the 1980's, the U.S. compensated for a shortage of domestic savings by permitting the dollar's nominal value to rise sharply. The appreciation of the dollar reduced American competitiveness, restrained manufacturing investment, and generated a large trade deficit which helped to produce higher savings in other countries for recycling back to the U.S. financial markets. If the U.S. had attempted to stabilize the dollar's nominal value by restraining interest rates during the mid-1980's, the domestic savings shortage would have been resolved through a sharp rise in the real exchange rate via higher domestic inflation. While one could argue that the balance of payments consequences would have been similar, a rise in the real exchange rate through higher inflation would have produced a vastly different economic climate in the U.S. than a balance of payments deficit resulting from appreciation of the nominal exchange rate. The consumption share of GNP would not have risen to the highest level in American history. There would have been a less severe shake-out in U.S. manufacturing industry and more capacity would be available for reducing the trade deficit today.

The big surprise in the financial markets during 1988 was the process by which America's real exchange rate appreciated. The country's heavy dependence on foreign central banks to finance its external deficit during 1987 suggested that the nominal exchange rate would remain weak during 1988 and that appreciation of the real exchange rate would occur through higher inflation. But instead the dollar's nominal value rose because several factors helped to revive private capital flows to the U.S. First, many investors believed foreign central banks would protect the dollar until the election. Secondly, the Federal Reserve moved quickly to increase U.S. short-term interest rates as the export boom pushed the economy closer to its capacity ceilings. Thirdly, the German government inadvertantly encouraged large private capital outflows by imposing with-holding taxes on many important domestic financial assets. The new German tax triggered heavy demand for high yield bonds in a variety of countries, including Australia, Denmark, and Canada, not just the United States, and depressed the D-Mark.

American policy makers were naturally pleased when the dollar rallied last year because it helped to restrain upward pressure on inflation and interest rates during the run-up to the presidential election. But the dollar's rally poses risks if it goes too far. Nominal appreciation of the dollar, coupled with an American inflation rate 3-4% higher than Germany and Japan's, will dampen U.S.

exports momentum later this year. Other countries are responding to dollar strength by raising interest rates and thus dampening prospects for world growth in 1990. Indeed, yield curves are now flat and inverted in several countries, not just the U.S. Finally, the pleasant side-effects of a dollar rally could divert the American public's attention from the need for a new economic policy mix, which does not depend upon rising interest rates and exchange rate overvaluation to resolve domestic savings imbalances.

There is nothing wrong with running a large trade deficit and importing capital if we invest it wisely. But, unfortunately, the rise now occurring in the business investment share of GNP still does not justify a current account deficit remaining above $130 billion through the early 1990's. Instead, we appear to be reverting to the initial Reagan policy mix of using monetary tightening and exchange rate appreciation to ration output because of capacity shortages which are themselves a by-product of the dollar overvaluation of the early 1980's. If such a policy stance continues for too long, it will squeeze manufacturing profits and discourage American industry from correcting the investment anorexia which occurred during the first half of the 1980's. Indeed, it could even set the stage for new capacity shortages if widening of the trade deficit depresses the dollar again during the early 1990's.

There is little the Federal Reserve can do to resolve this policy dilemma. If it restrains the exchange rate by holding down interest rates,the real exchange rate will appreciate through higher inflation. If it tries to restrain inflation by tightening, the dollar's nominal value will rise and worsen the prospects for U.S. trade improvement unless domestic demand weakens significantly. In a world financial system increasingly dominated by large pools of money chasing short-term yield differentials, monetary policy is not as optimal a tool for restraining domestic spending as it was in the days when capital was less mobile.

Since the U.S. is trying to shift resources from domestic consumption to exports and investment, the optimal way to restrain domestic spending under current circumstances would be a fiscal program heavily oriented towards consumption taxes or cuts in public spending. Such a package would free up resources for reducing the trade deficit without jeopardizing the capital spending boom now in progress throughout the manufacturing sector. In fact, with the trade deficit still equal to 2.6% of GNP or more than output lost in the average post-war recession, the U.S. has a historically unique opportunity to maintain an extended period of steady growth with full employment even if Congress balances the federal budget by 1994.

Savings & Investment as a % of GNP

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Gross Savings	16.2	17.1	14.1	13.6	15.1	13.2	12.3	12.5	13.2	13.0	13.2	13.5	13.8
Gross Private Savings	17.5	18.0	17.6	17.4	17.9	16.5	15.8	14.7	15.0	15.0	15.1	15.2	15.3
Personal Savings	5.0	5.2	4.9	3.9	4.4	3.1	2.8	2.3	3.0	3.2	3.4	3.6	3.7
Retained Earnings w/IVA. . .	1.4	1.4	0.6	1.9	2.5	2.6	2.2	1.6	1.6	1.5	1.4	1.4	1.4
Depreciation	11.1	11.4	12.1	11.6	11.0	10.8	10.8	10.8	10.4	10.3	10.3	10.2	10.2
Government Surplus.	-1.3	-1.0	-3.5	-3.8	-2.9	-3.3	-3.5	-2.2	-1.8	-2.0	-2.0	-1.7	-1.5
Federal.	-2.2	-2.1	-4.6	-5.2	-4.6	-4.9	-4.8	-3.3	-3.0	-3.0	-3.0	-2.8	-2.7
State & Local.	1.0	1.1	1.1	1.4	1.7	1.6	1.3	1.1	1.2	1.0	1.0	1.1	1.2
Gross Investment.	16.5	17.2	14.1	13.8	15.2	13.1	12.3	12.3	13.0	13.0	13.2	13.5	13.8
Gross Private Domestic Invst.	16.0	16.9	14.1	14.7	17.6	16.0	15.7	15.8	15.8	15.5	15.5	15.7	15.7
Private Domestic Invst. . .	16.3	16.1	14.9	15.0	15.8	15.7	15.3	14.8	14.8	14.8	14.8	15.0	15.0
Nonres. Fixed Invst.. . . .	11.8	12.1	11.6	10.5	11.0	11.0	10.2	9.8	10.1	10.1	10.1	10.2	10.2
Res. Fixed Invst..	4.5	4.0	3.3	4.5	4.8	4.7	5.1	5.0	4.7	4.7	4.7	4.8	4.8
Change in Bus. Invt. . . .	-0.3	0.8	-0.8	-0.2	1.8	0.3	0.4	0.9	1.0	0.7	0.7	0.7	0.7
Net Foreign Investment.	0.5	0.3	0.0	-1.0	-2.4	-2.9	-3.4	-3.5	-2.8	-2.6	-2.3	-2.2	-1.9
Statistical discrepancy	0.3	0.1	0.0	0.2	0.1	-0.1	-0.1	-0.2	-0.2	-0.1	-0.1	-0.0	0.0
Addendum:													
Federal Surplus	-2.2	-2.1	-4.6	-5.2	-4.6	-4.9	-4.8	-3.3	-3.0	-3.0	-3.0	-2.8	-2.7
Exc. Social Security.								-3.7	3.8	-3.9	-4.0	-4.0	-4.0
Social Security								0.4	0.8	0.9	1.0	1.2	1.3

1. The persistence of large government deficits will make it difficult to push the current account deficit below 2.3% of GNP by 1990 ($130-135 billion) unless personal savings rise sharply or private investment contracts. It will be difficult to increase corporate savings (depreciation and retained profits) because of the adverse effects of the 1986 tax reform bill on investment allowances and low unemployment on wage costs.

FEDERAL RESERVE BANK OF DALLAS
TRADE-WEIGHTED VALUE OF THE DOLLAR

Real Index (RX-101)

	1987	1988											
1973:Q1 = 100	Dec.	Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Oct.*	Nov.*	Dec.*
Total	93.2	2.1	92.4	91.1	90.2	90.2	91.1	92.9	93.7	94.9	92.6	90.7	90.3
Europe	81.7	82.6	84.9	83.6	82.9	83.8	87.2	91.8	93.8	93.8	91.4	87.7	87.7
PACNIC	104.9	104.1	103.7	103.3	103.1	102.7	102.5	102.8	102.4	103.0	102.6	100.9	100.8
Canada	115.1	113.2	111.6	108.9	108.8	108.7	107.2	108.1	107.8	108.7	108.8	107.9	108.0
Japan	52.4	52.3	53.2	52.4	51.5	51.6	52.9	55.7	56.0	56.3	54.0	51.6	51.7
W. Hemisphere	145.7	143.3	138.7	137.0	134.6	133.6	131.6	128.9	129.2	136.8	n.a.	n.a.	n.a.
Other	107.9	107.4	107.7	107.2	105.8	104.9	104.7	107.3	107.5	108.6	n.a.	n.a.	n.a.

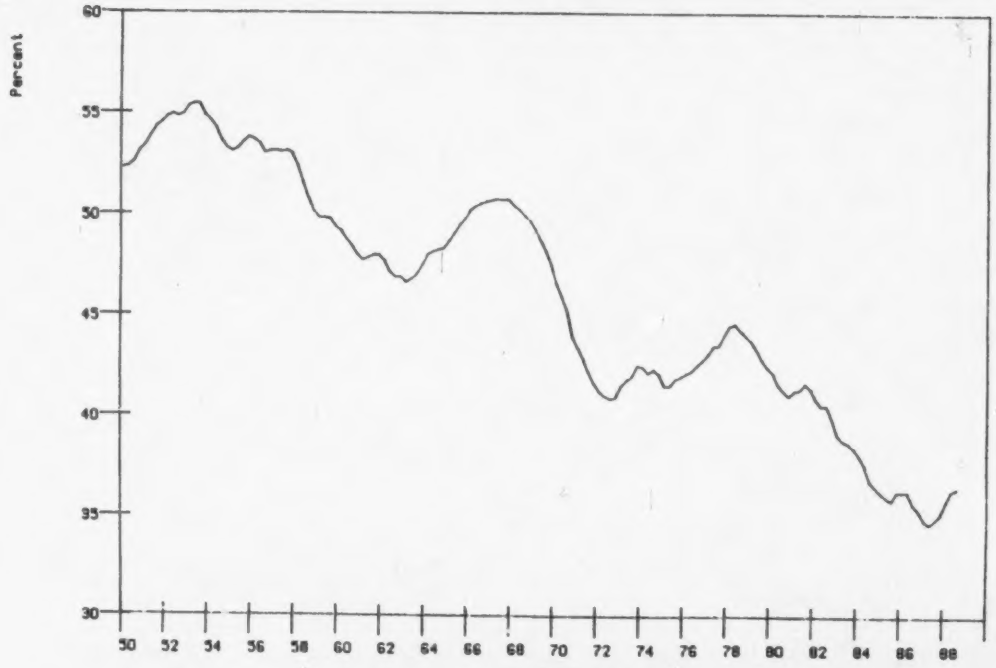
* Estimated.
n.a.—Not available.
Note: PACNIC refers to Pacific newly industrialized countries; W. Hemisphere excludes Canada.

Nominal Index (X-131)

	1987	1988											
1973:Q1 = 100	Dec.	Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Total	199.2	192.7	195.0	193.8	193.0	194.1	197.0	202.1	204.9	206.5	203.6	201.0	201.4
Europe	107.5	108.1	111.1	109.4	108.7	109.8	114.2	120.0	122.6	122.2	119.5	115.0	114.7
PACNIC	128.0	125.0	124.9	124.1	123.7	123.6	123.4	123.6	123.5	123.7	123.2	121.3	121.1
Canada	131.1	128.9	127.2	125.3	123.6	124.1	122.1	121.1	122.6	123.0	120.9	122.1	120.0
Japan	45.6	45.2	45.8	45.1	44.3	44.2	45.1	47.2	47.4	47.7	43.7	43.7	43.6
W. Hemisphere	7,800.0	8,943.2	9,277.8	9,580.7	9,888.9	10,169.2	10,485.1	10,810.6	11,182.0	11,711.5	12,080.6	12,634.8	13,163.7
Other	350.1	381.3	384.6	384.0	383.1	381.5	384.0	404.8	407.9	412.1	411.1	408.4	408.3

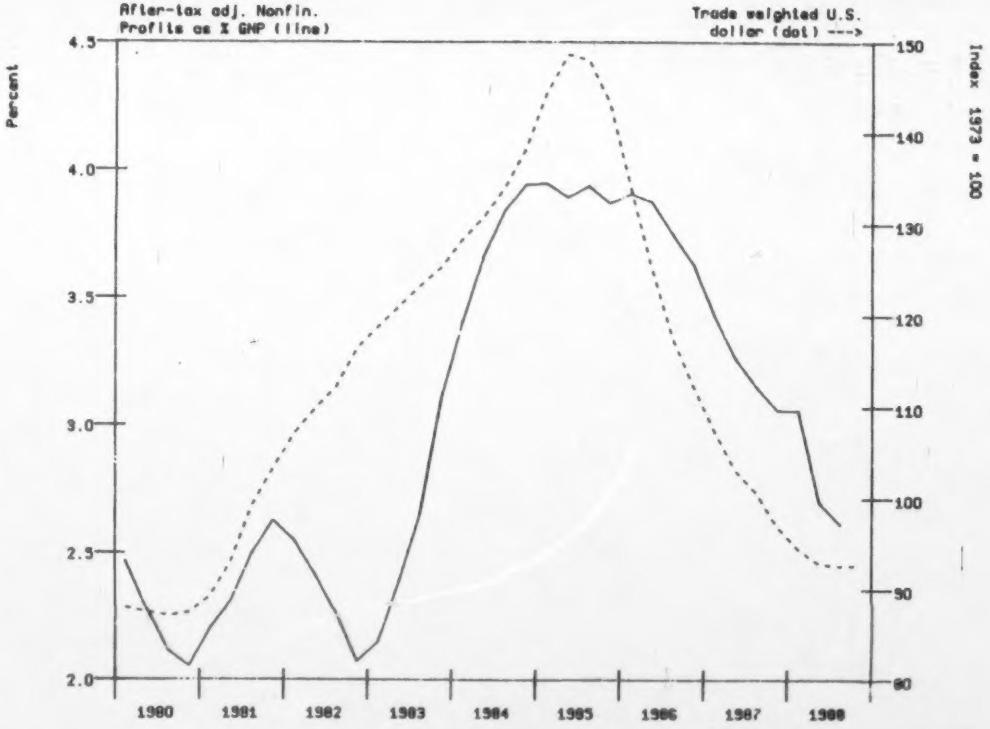
2. The dollar has risen by 7-8% in real terms against the currencies of Europe during the past twelve months but the mid-year rally vis a vis the yen was reversed during the final weeks of 1988. The exchange rates of East Asia are probably rising by more than the index suggests because effective inflation rates in the region are at close to double digit levels.

Manufacturing Pre-tax Corporate Profits with IVA
as a % Total



12 qtr. moving avg.

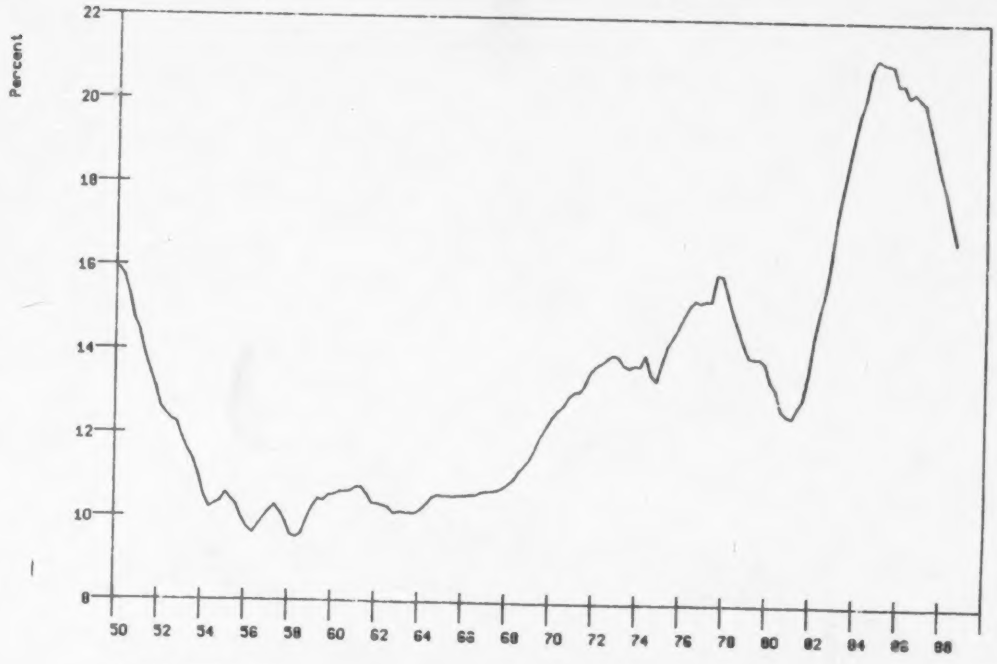
3. One of the reasons why it would be dangerous to use exchange rate overvaluation as a mechanism for constraining inflation is that it will slow the income shift from retail profits to manufacturing profits which is a necessary counterpart to the U.S. improving its balance of payments and revitalizing its manufacturing sector. Despite last year's industrial boom, the manufacturing share of total profits is still well below the



4 qtr. moving average

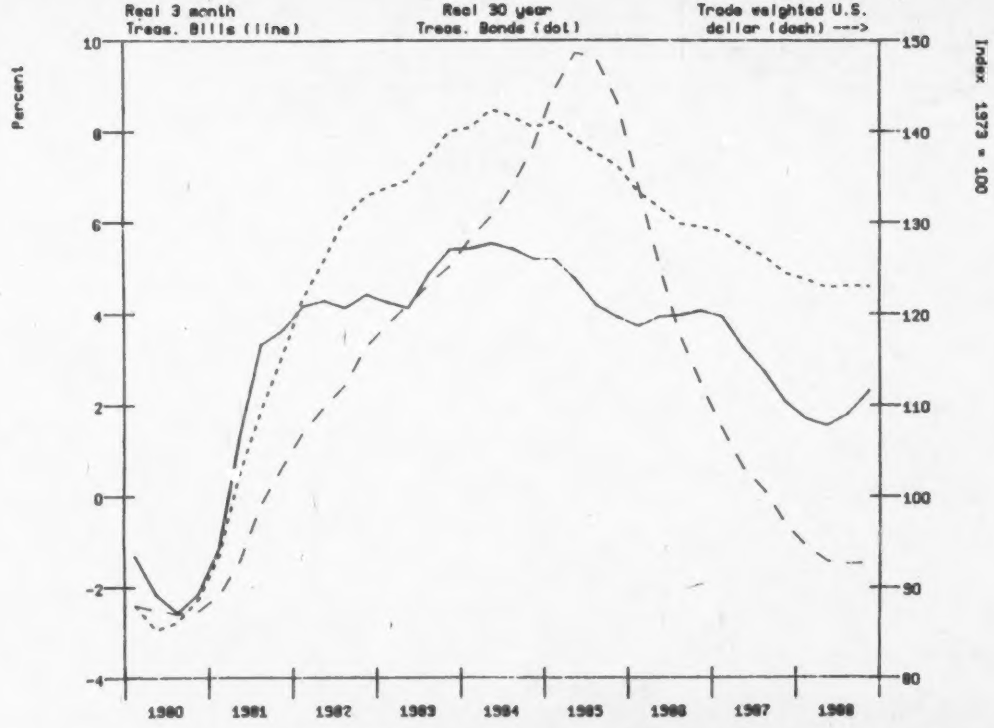
5. One of the factors which helped to drive the dollar higher during the first half of the 1980's was an increase in corporate profitability resulting from the 1981 tax bill and the impact of high unemployment on wages. The upsurge in corporate profitability made American financial and real assets more attractive than those in many other countries, inducing a capital inflow from overseas.

Pre-tax Corporate Profits with IVA
Wholesale & Retail Trade
as a % Total



12 qtr. moving avg.

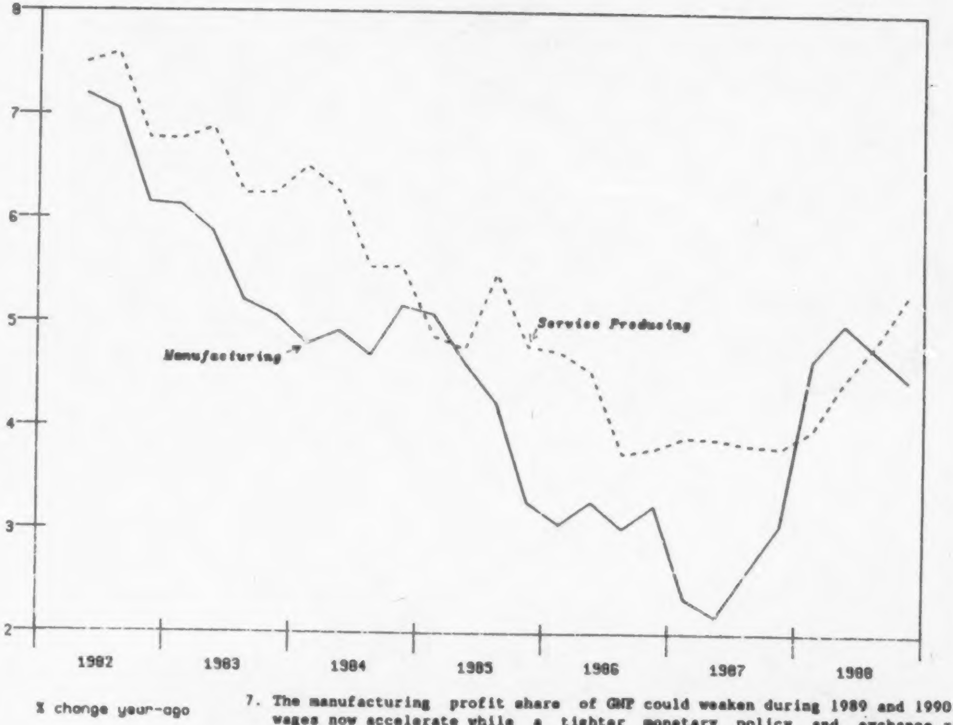
4. Retail profits have begun to contract but have further to go on the downside.



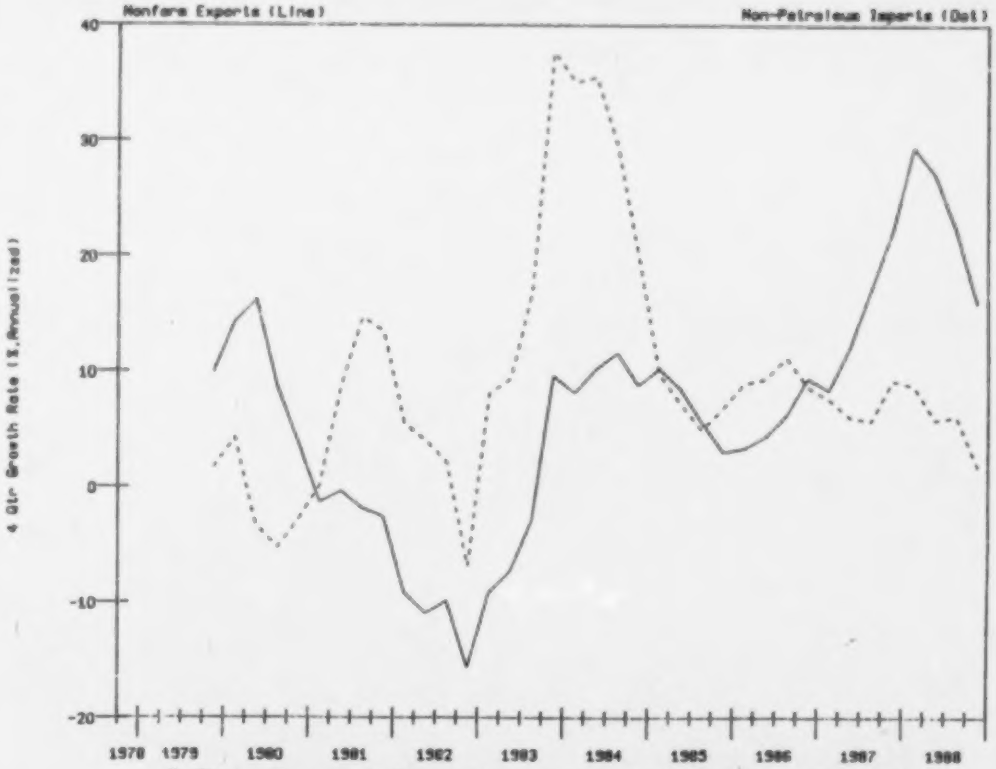
4 qtr. moving average

6. The rise in the corporate profit share of GNP also increased the American economy's tolerance for high real interest rates. Hence, while a larger share of the capital flow to the U.S. after 1982 was invested in fixed income instruments, the high real return available on such paper was not autonomous from the higher returns being earned by companies. In fact, they were highly complementary.

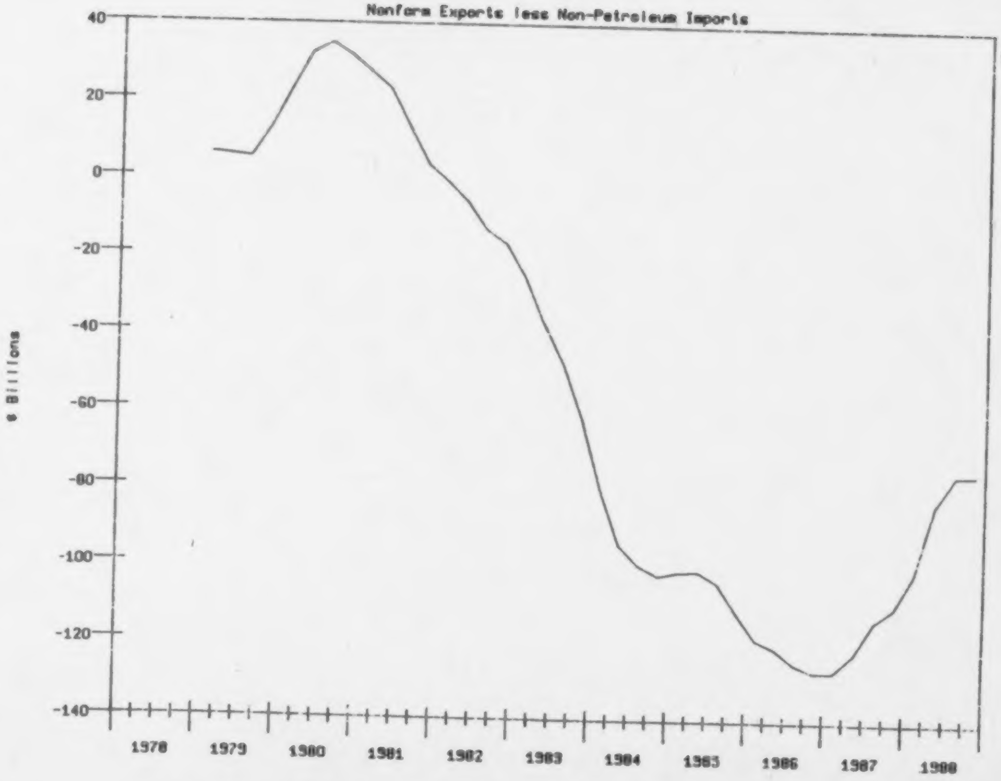
Employment Cost Index
Total Compensation



7. The manufacturing profit share of GNP could weaken during 1989 and 1990 if wages now accelerate while a tighter monetary policy and exchange rate appreciation reduce the ability of companies to raise prices. As the new Employment Cost Index data will testify, compensation costs are starting to rise much more rapidly in the manufacturing sector because of stronger output growth.



8. The growth rate of U.S. non-farm exports peaked at 30% in early 1988 and will soon be at single digit levels. The year on year growth rate of non-oil imports has slowed to 1-2% but may accelerate in 1989 if domestic demand remains robust.



9. The trade deficit for manufactured goods in constant dollars has been static since the second quarter of 1988.

SECTION TWO

This section of the testimony reviews how America's special relationship with Japan played an important role in helping this country to cope with its large external financial requirements during 1987 and 1988. Not only did Japan's central bank play a leading role in the dollar support operations of 1987 and early 1988; Japanese monetary authorities also kept interest rates at low levels in order to lessen selling pressure on the dollar and encourage strong world econoimc growth. But while Japan has been a great ally in protecting America from macroeconomic instability, her microeconomic policies pose an increasingly serious competitive challenge to both American industry and financial institutions. Much has been written elsewhere about the role of the Japanese government in using industrial policy to promote the development of new export sectors. A new issue worthy of attention is the role being played by the Tokyo stock market in powering Japan's expansion as a global financial power. During the 1980's, the Tokyo stock market has risen so sharply that it now accounts for 45% of all world stock market capitalization compared to only 17% eight years ago. Many western analysts have long predicted that it would crash, but because of the market's unique institutional features it appears to be less vulnerable to shocks than other stock markets. These features include large corporate cross-shareholdings, domination of the market by four large brokers, fixed brokerage commissions, regulatory controls on the supply of new stock, and active government intervention to prop up share prices when necessary. As a result of the formidable competitive challenge which will be posed by Japan's financial institutions both here and elsewhere in the world during the 1990's, the behavior of the Tokyo stock market is now a legitimate subject for examination by American policy makers. As the final section will indicate, it will probably be impossible for American banks to compete with Japanese banks in the decade ahead because of differences in the two countries' stock market practices. Hence, the U.S. government will ultimately have to rethink its regulatory framework for domestic financial institutions or face growing domestic pressure for a managed trade agreement with Japan in financial services.

POLICY IMPLICATIONS OF THE TOKYO STOCK MARKET BOOM

There have been two major upheavals in the national distribution of world stock market capitalization during the past one hundred years. The first occurred during the early years of the 20th century when rapid expansion of the American economy and the crippling effects of the First World War on Britain caused New York to displace London as the world's dominant capital market. The second occurred during 1987 and 1988, when Japan's share of world stock market capitalization shot up to 45% while America's receded to modestly below 30% from 55% at the start of the decade. Some of the decline in America's share of world equity market capitalization resulted from large scale share repurchases by the U.S. corporate sector itself, but even if we broaden our definition of corporate capital to include bonds as well as equity the U.S. corporate sector has a market value of only about $3 trillion today compared to $4 trillion for Japan.

Although the dramatic decline in America's share of world stock market capitalization has so far elicited less media comment than the country's re-emergence as an external debtor, it is a more significant event for two reasons. First, it provides a provisional market verdict on the U.S. economic policies of the 1980's. Whether a country is a debtor or a creditor says little about its economic performance, except that it has less savings than investment. During the early 20th century, America's external borrowing did not prevent the U.S. from overtaking Britain in both national income and stock market capitalization because the borrowing was financing expansion of the nation's capital stock. In the 1980's, by contrast, America has been borrowing on twice as large a scale in terms of GNP shares as it did during the 1880's, but the growth rate of its capital stock has not accelerated while its share of world stock market capitalization has been halved. The low value being placed on U.S. equities suggests that investors are deeply distrustful of the long-term economic legacy of the Reagan Administration. In stock market jargon, they are putting a low valuation on current company earnings because they fear that policy contradictions still present in the system will produce either a sharp drop in profits or a large rise in the level of interest rates. Although there is no way to pinpoint exactly what event might trigger such trouble, the list of potential candidates is well known. Congress might hike business taxes to lower the federal deficit. Shortages of labor and manufacturing capacity could generate new upward pressure on inflation and interest rates, setting the stage for a recession. There could be another squeeze on U.S. manufacturing corporate profits in 1989-90 if wage costs escalate while fiscal and monetary gridlock in Washington produces a sharp appreciation in the dollar exchange rate.

The second reason why the sharp decline in the U.S. share of world stock market capitalization deserves more notice is because of what it tells us about America's future competition. Practically all of the decline in America's share of world equity market capitalization during the 1980's was matched by growth in Japan's share. The extraordinary growth of Japanese economic power during the Reagan years is of great historic consequence because of what it portends for both the future management of the world economy as well as the probable evolution of new American ideas about the role of government and the marketplace in shaping the country's economic destiny. Although the 1980's will go down in the political history books as a neo-conservative era, the dramatic expansion of Japanese financial power is not an endorsement of laissez faire capitalism and the simplistic free market economic dogma which Reagan and his Chicago trained economists brought to Washington nine years ago; it represents instead the triumph of a different set of institutions which have traditionally gone under the label of corporatism. Corporatist economic systems, like capitalist ones, have private ownership and use the marketplace as a screening device to allocate resources, but they do so within a framework which strives to achieve targeted objectives rather than trusting the market, alone, to insure that national interests are served. In contrast to a pure command economy, the Japanese bureaucracy does not directly proscribe investment decisions while public expenditure as a share of GNP is actually below America's. Rather, government plays a prescriptive role by using a diverse mixture of tax incentives, subsidies, and active coordination of private decision-making to encourage the development of new high value added industries and the orderly contraction of declining ones. Japanese firms are not compelled to comply with government plans, but the incentives for cooperation are strong because the senior civil service is staffed by highly competent professionals who work so effectively with the private sector that they often finish their careers in top corporate jobs.

Much of the rise in the Tokyo stock market during the 1980's can be explained by traditional economic variables such as liquidity and profits. Since 1950, Japan has consistently had a high rate of savings and low cost of capital. In the mid-1980's, the excess liquidity in her financial system swelled to record levels because of a boom in export sales to America and a collapse in the yen price of her commodity imports. In 1988, for example, Japanese oil imports cost a sum equal to only 1% of GNP compared to 6% in 1980. Meanwhile, Japanese corporations have shown themselves highly adaptable at coping with large exchange rate fluctuations. As a result, corporate earnings remained strong as Japan switched from export to domestic led growth after 1986 and the consolidated price/earnings multiple of the Tokyo market is likely to drop to 35 this year from a previous high of 52 in 1986. But many countries have enjoyed good economic records without experiencing such dramatic increases in their stock markets. Another factor which has bolstered the Tokyo market during recent years is its emergence as an instrument of government economic policy. After years of playing a negligible role in the economy, the Tokyo stock market has recently become a major source of funds for the Japanese government, the banks, and manufacturing companies restructuring their operation to cope with the strong yen. The public sector has been privatizing several large companies, including the national telephone company, the railways, and a state airline. Japanese retail investors have been prepared to purchase shares of privatized companies at extravagant p/e ratios in expectation that the government would encourage their prices to appreciate. Nippon Telephone, for example, sells at a p/e of 120 and has a market capitalization of over $300 billion because of its perceived niche as a government stock. Japanese banks also have had to raise a large amount of equity capital in order to comply with the new Bank of International Settlements capital/asset guidelines. In the U.S., such heavy fund raising would ordinarily depress share prices. In Japan, by contrast, both brokers and bank customers helped to ramp bank share prices in order to insure that the Japanese financial system was recapitalized on attractive terms. Such exercises in financial networking would be considered illegal in the United States, but Japanese companies regard mutual cross-shareholdings as a logical way to enhance business relationships. While there is no precise way to measure the impact of these share support operations on market prices, it is interesting to note that Japanese bank share prices appear to correlate highly with the level of corporate cross shareholdings. Among the big thirteen commercial banks, the lowest price/earnings multiple belongs to Kyowa Bank, which has decided to scale back low return corporate lending and develop more consumer lending. Because of its shift in business focus, industrial firms have seen selling their Kyowa shares and the p/e is only 45 compared to nearly 70 for other commercial banks despite the fact that Kyowa enjoys a very strong balance sheet and excellent earnings growth. If all thirteen of Japan's largest commercial banks sold at a p/e of 45, the capitalization of the group would be only $325 billion compared to the $500 billion of market value which they currently enjoy as a consequence of Tokyo's unique capacity for cooperative leveraging of share prices. The buoyancy of the Tokyo stock market itself has also helped the Japanese banks to comply with the BIS rules because bank regulators in the U.S. and Europe made the mistake of letting banks include in their capital bases 45% of their unrealized gains on equities and real estate. As a result of the rule, it is not surprising that many Japanese banks have significantly increased their loans to medium sized companies for stock market and real estate speculation. Buoyant markets in real estate and equity prices automatically strengthen bank balance sheets. Because of their access to cheap equity, Japanese banks are likely to dominate the world financial system during the 1990's. American banks, by contrast, will be constrained by low share price multiples and a stock market capitalization of only $95 billion for the nation's fifty largest institutions.

As with Japanese industry, official guidance of the Tokyo stock market is usually prescriptive rather than proscriptive because the players know their roles without the government having to use overt controls. In contrast to other major stock markets, four brokers control 40-50% of Tokyo's trading volume. Nomura, alone, accounts for about 20%. In New York, no U.S. broker has a market share in excess of 7%. Also in contrast to America and Britain, Japanese brokerage houses still enjoy fixed commissions, which provide them with profits large enough to offset trading losses incurred supporting the market during periods of stress. The supply of stock is restricted as well. More than half of all equity is tied up in corporate cross shareholdings while new issues are far less common than in other countries. Between 1977 and 1986, for example, fewer than 200 new companies went public in Tokyo despite the buoyancy of the market. As new issues usually command a large scarcity premium in the aftermarket, the brokers can use the distribution of new underwritings to reward investors who are helpful in supporting the share prices of troubled companies. As the recent Recruit Cosmos scandal will testify, share placements are also a useful way for newly emerging firms to develop good political contacts. Finally, the Japanese government will intervene directly to bolster the market if financial pressures develop which threaten to overwhelm the ability of the brokerage houses and large institutions to protect share prices. In the months after the October 1987 stock market crash, for example, the Ministry of Finance relaxed the accounting standards for the country's Tokkin Funds. Instead of requiring them to report their assets at the lower of cost or market, they were permitted to report asset values at the higher of cost or market in order to lessen the danger of them reporting large trading losses which might have resulted in new waves of selling. In recent weeks, the MOF also has begun to warn foreign stock brokers against implementing program trading strategies in the Tokyo futures market which produce volatility in the cash market. Once MOF understands the full implications of having a futures market, it may impose so many restrictions on futures trading that the market will cease to be an effective vehicle for large-scale hedging and arbitrage activity.

Japan Still Needs America

The rise of Japanese financial power does not pose a threat to the American people. Japan's capital power will enhance her ability to dominate many of the new high technology industries of the 1990's, but she will still be highly dependent upon America for both markets and military security. As was apparent during 1987 and 1988, Japan has such an overwhelming interest in American economic and political stability that she will probably use her creditor power to prop up America's financial system and prevent a recessionary hard landing to our nation's experiment in deficit finance. Indeed, the buoyant economic back-drop to the Bush inauguration was more of a tribute to Japanese policy discretion than a celebration of American policy coherence.

Japan's central bank played a major role in supporting the U.S. dollar during the currency stabilization efforts of 1987 and 1988, and still keeps over 90% of the country's $90 billion of foreign exchange reserves in dollar denominated assets -- a level matched only by Canada. The Ministry of Finance also used its regulatory powers to prevent Japanese private investors, such as the life insurance companies, from selling American bonds during periods in 1988, when the market was nervous about the dollar's value. Mr. Akio Mikuni, who runs Tokyo's major independent credit rating agency, estimates that Japanese insurance companies have lost about 3 trillion yen ($24 billion) on their dollar bond portfolios and that the government has lost over twice as much on dollar support operations. In addition to buying dollars and using moral suasion over private capital flows, the MOF lobbied hard for Japanese monetary policy itself to remain expansionary throughout 1988 despite the danger of economic overheating and inflation. In 1987, it was even fashionable for financial commentators to compare the easy money policy which Japan was pursuing on behalf of the dollar to the expansionary monetary policy which the New York Federal Reserve Bank had pursued during the late 1920's to bolster the beleagured British pound. As in Tokyo during 1987, the New York Fed's low interest rate policy helped to generate a great stock market boom which eventually culminated in the 1929 crash. In most other countries, a monetary policy as expansionary as Japan's after 1986 would have produced a boom-bust cycle in asset prices but they have not in Japan both because of the unique institutional levers by which the government has been able to support the stock market during periods of stress as well as the government's use of non-market mechanisms to prevent credit growth from climbing to dangerously high levels when interest rates have been restrained to support the dollar. Private analysts estimate that the Bank of Japan used administrative credit controls to knock about 2% off Japanese monetary growth during the past six quarters. The real estate market is also subject to far more official guidance than would be the case elsewhere. After sky-rocketing during 1986 and 1987, Tokyo real estate prices fell by nearly 30% during 1988 as the government clamped down on lending, but there is little sense of panic among private investors because of the perception that the government will also use administrative guidance to regulate the availablity of new land for commercial and residential development. Although it is often argued that central banks can no longer guide asset markets, private investors make a distinction between Japan's monetary authorities and those of other countries because of their perception that Japan can use non-market mechanisms to guide capital flows and manage exchange rates. As one Tokyo official explained to foreign visitors last year, "our bubbles don't burst." As a result, senior Japanese officials can often influence psychology in the financial markets simply by signalling that they favor a correction in prices. Indeed, it was no accident that the U.S. dollar fell sharply in the days immediately before and after America's presidential election in November, 1988. Many traders believed that Japan would support the dollar through October in order to boost the Bush candidacy but then take it lower during 1989 in order to sustain improvement in the U.S. trade account.

The MOF's activities during the run-up to the 1988 American presidential election campaign is not the first time that currency intervention has served as an instrument of foreign policy. In the late 1960's, the U.S. actually developed a special balance of payments "offset program" with Germany, in which exchange rate stabilization became a de facto form of defense subsidy. Under the "offset program", Germany agreed to take four actions as a quid pro quo for American defense spending on its behalf; the Bundesbank ceased converting dollars into gold, the German government purchased a large tranche of U.S. Treasury bonds, the German armed forces agreed to increase the U.S. market share in their equipment orders, and the German government agreed to increase expenditures on improving the physical quality of U.S. military installations in the country. While the U.S. has not formally attempted to resurrect the "offset" concept, the activities of the BOJ and MOF during 1987 and 1988 were a surrogate form of burden sharing comparable to the "offset" program of the late 1960's. Japanese use of the currency market as an instrument of defense and foreign policy is not a totally new phenomena either. In the first decade of this century, Japan also used its external reserves for non-economic purposes. Japan deposited most of its foreign exchange reserves in London (they were the second largest in the world) in order to enhance a special relationship with Britain which [illegible] British recognition of Japanese supremacy over Korea and access to the London credit market during the 1905 war with Russia. Although Japanese financial cooperation was of only modest importance to Britain eighty years ago compared to America's dependence upon it during recent years, it provides a useful illustration of the strong role political factors can play in the conduct of Japan's external economic relations. The growth of German and French economic power was creating competition for the pound as the world's dominant reserve currency after 1900, so Japanese assistance in managing gold flows was a useful quid pro quo for British acceptance of Tokyo's foreign policy goals. Indeed, by 1913, the pound accounted for only about 38% of global foreign exchange reserves compared to levels more than twice as high in the late 19th century.

But Japan Now Poses An Institutional Challenge

The most positive development in the world economy during the late 1980's has been the willingness of Japan to accept the responsibilities of being a world creditor power far more quickly than the U.S. did during the 1920's, when Britain was in decline and America became the world's largest capital exporter. Until recently, Japan appeared to be so insular that it was easy to argue she would move even more slowly than America during the 1920's in accepting a larger global role. But while Japan helped to shield Ronald Reagan from the great contradictions in his economic policies during 1987 and 1988, the sheer scale of her new economic power increasingly poses an ideological challenge to the ascendancy of the neo-conservative movement which Reagan brought to power eight years ago. Japan has demonstrated that an economic system other than America's can produce superior outcomes. It was University of Tokyo Law School graduates presiding over the Finance Ministry of the industrial world's least deregulated economy who rescued the international system from currency misalignments and financial crises produced by economics graduates of the University of Chicago. Indeed, the Reagan administration has implicitly acknowledged an upheaval in global economic power by itself presiding over a quiet shift towards more corporatist economic policies.

During the 1988 election campaign, it was often argued that a Democratic victory would produce a political swing towards protectionism and industrial policy. But as is often the case in American history, the U.S. did not need to switch political parties in order to change economic policies. Because of concern about the country's declining competitiveness and the rise of Japanese technological prowess, the Reagan administration has actually pursued more interventionist trade and industrial policies than any American government since the 1930's. The Reagan administration increased the share of U.S. imports subject to some form of restraint from 12% in 1980 to 24% recently. President Reagan also signed a trade bill which greatly increases the danger of "procedural protectionism" by widening the legal criteria available to the executive branch for pursuing future trade retaliation through unilateral rather than multilateral channels. Finally, his administration launched an unprecedented number of non-military high technology industrial policy initiatives, including federal subsidies for commercial research on semi-conductors and super-conductors which would be regarded as illegal under the 1988 trade act if undertaken by other countries' governments. Moreover, these experiments are probably just the start of an ongoing change in federal attitudes towards high technology industrial policy. American electronics companies are now lobbying for Washington to help launch a U.S. high definition TV industry before Japan totally dominates that market. The Pentagon is increasingly alarmed about America's declining ability to produce many manufactured goods and to maintain parity with Japan in the commercial application of technology.

The evolution of managed trade agreements and industrial policy during the Bush administration is unlikely to be accompanied by any more overt transformations in American policy slogans and ideology than it was during the Reagan years. The Republicans dislike labels which smack of state planning while the dollar devaluation is revitalizing the political credibility of the export lobby. But whatever the slogans, the major driving forces in American political economy during the early 1990's will be fear of Japan achieving supremacy in high technology industry and using her immense creditor power to enthrone the yen as the world's dominant financial currency.

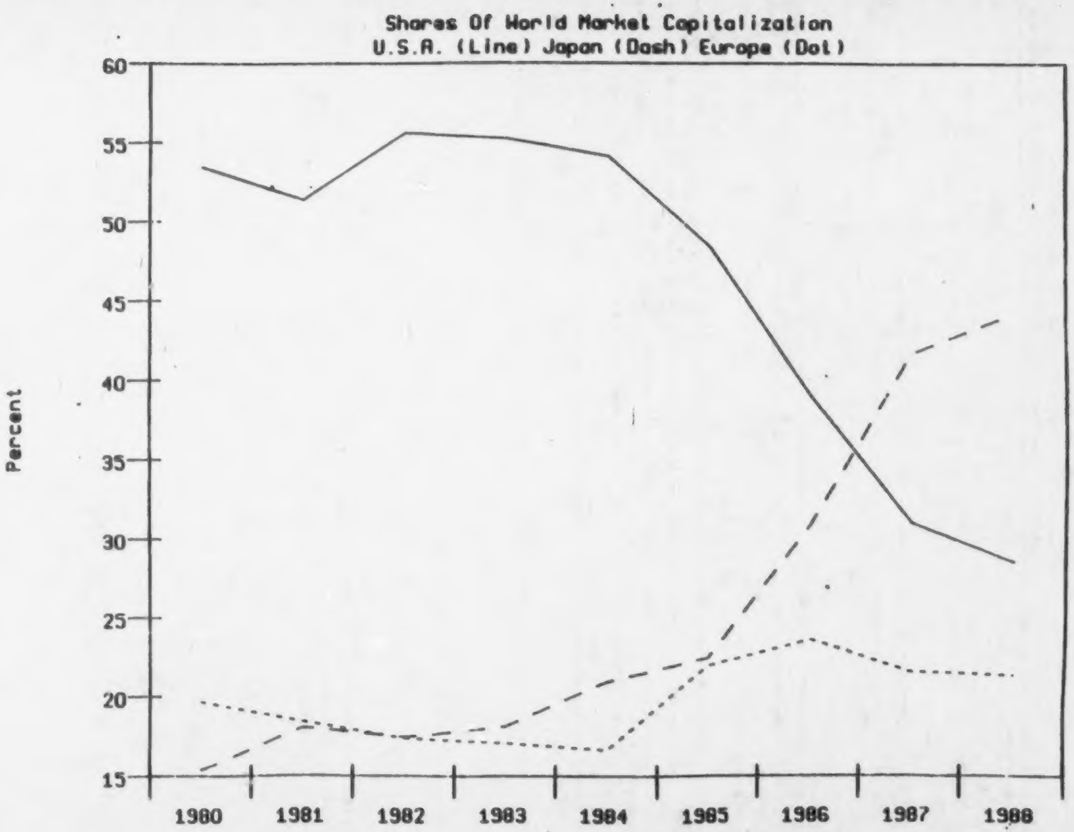
As dollar support operations have emerged as a major de facto form of burden sharing, the U.S. can probably persuade Japan to move slowly in officially promoting the yen as an international reserve currency. Senior Japanese officials appear to understand even more clearly than American officials the seigniorage benefits which the dollar's "key currency status" still conferrs upon the U.S. in funding its external deficit and remaining a global military power. The problem for America in restraining the yen's rise as a reserve currency during the 1990's is that the U.S. Treasury under Donald Regan lobbied aggressively for Japanese financial deregulation in order to encourage a revaluation of the yen. As a result of banking deregulation, rapid growth of the commercial paper market, and the MOF's decision to launch a Treasury bill in the near future, it is now estimated that Japan will have a money market equal to 50% of her GNP by 1990 compared to 10% of GNP eight years ago and 30% for the United States. In dollar terms, the Tokyo money market could be as large as New York's, although still far smaller than the global market in short-term dollar instruments. Such a dramatic change in the structure of the Japanese financial system will make it more difficult for Japan's central bank to use administrative guidance and other non-market policy levers to protect the American dollar if Washington persists with irresponsible economic policies. Reflecting yet again Japan's extraordinary capacity for adaptability since the Meiji Resotration of 1867, a change imposed by foreigners to slow Japan's economic momentum may now be turned against them.

At some point in the not too distant future, American financial institutions are also likely to start lobbying for protection against the Japanese on the grounds that it is impossible to compete with banks and brokerage houses which enjoy the benefits of an "officially guided stock market". Although few American officials have yet thought through the policy implications of the Tokyo stock market's unique institutional features, it is not difficult to imagine the questions which they will ask. Should one firm be permitted to control 20% of Tokyo's trading volume and thus implicitly 10% of the world's? What advantages do fixed commissions give to Japanese brokerage firms in managing markets? If Japanese share prices can be guided through corporate cross shareholdings, was it a mistake to permit Japanese banks to include 45% of their unrealized holding gains on equity and real estate in their BIS capital/asset ratios? Since Tokyo real estate prices are an important prop to the Tokyo stock market, should other countries lobby for deregulation of the Japanese real estate market? Should U.S. banks be permitted to develop corporate cross-shareholdings with industrial firms in order to meet the competitive challenge posed by Japanese banks during the 1990's? Do we need managed trade in financial services to compensate for the special fund raising advantage which the Tokyo stock market conferrs upon Japanese financial institutions? As financial services are already one of the most restricted segments of the world trade, alarm about Japanese banking power is unlikely to make U.S. commercial policy much more protectionist than it is already. But America's financial authorities will probably employ a variety of bureaucratic stalling devices to restrain the growth of Japan's share of the domestic American banking market (now about 11%).

The most troublesome issue likely to confront Washington in coping with Japanese economic and financial power will be growing pressure to experiment with industrial policy. It is far from clear that America can benefit from such tinkering without a more self-conscious intellectual revolution in the way she defines the role of government. Except for periods of war, the U.S. has never had an elite high calibre civil service comparable to the one which Japan developed to guide her emergence as a great industrial power. As a result, the American business sector does not often regard government policy as a credible anchor for its own actions. There also is a great danger that American politicians will turn to microeconomic forms of intervention as an expedient way of avoiding the macroeconomic sacrafices which will be necessary to correct the country's structural problems, such as a low savings rate. As the contrast between East Asia and South Asia will testify, microeconomic intervention can work only if it is undertaken by institutions which enjoy private sector support and is reinforced by macroeconomic policies which encourage savings and investment. There would also have to be well understood parameters for defining when microeconomic intervention is appropriate and when it is simply a cover for bailing out lame duck industries. As in Japan, American civil servants and politicans would have to understand that industrial policy is for anticipating and facilitating market change, not resisting it.

A few academic economists, such as Dr. Paul Krugman, have begun to redefine the traditional debate about free trade theory by examining the circumstances in which a country might achieve oligopoly profits from targeting investment. But the strategic trade theorists are cautious academics unwilling to make pretentious claims for their theories. As a result, it may take another decade of trial and error experimentation for America to develop a coherrent framework for reconciling its traditional beliefs with the success of Asian countries which recognize that comparative advantage in a technological age is a function of human social organization and conscious public policy decisions about how to allocate economic resources, not hereditary resource endownment and invisible market forces.

Although unique institutional differences can explain only a modest portion of Japan's economic achievements compared to traditional factors such as hard work or a high level of savings and investment, the outside world's need to understand and in some cases compensate for such institutional differences will inevitably expand as Japan's economic power grows. It mattered little to other countries if civil servants and brokerage houses could turn the Tokyo stock market into a steam-engine for promoting Japanese economic expansion when it accounted for only 5-10% of world stock market capitalization. But now that Japan accounts for nearly 20% of industrial world GNP and 45% of world stock market capitalization, every institutional difference which appears to enhance her economic power is likely to be scrutinized elsewhere for possible challenge or imitation. Just as late starters in the 19th century industrialization process, such as Japan and Germany, diverged from Anglo-Saxon free market economic ideology in order to close the gap with Britain, so traditional free market economies which are now falling behind Japan will have to adapt to her successful use of corporatist policies by themselves becoming more self-conscious about economic issues which they formerly took for granted. Indeed, despite the different historical starting points, American industrial policy may now be evolving in much the same eclectic and reactive fashion as Japan's did in response to the threat of foreign domination during the early decades of the Meiji Restoration. For as Chalmers Johnson noted in his history of MITI, "An individual interested in the Japanese system has no set of theoretical works, no classicus such as Adam Smith or V.I. Lennin, with which to start... industrial policy "just grew!"



1. The Japanese share of world stock market capitalization has risen dramatically during the 1980's.

[illegible]	Nomura Worldwide	Daiwa Securities	Nikko Securities¹	Yamaichi Securities	Total	The 10 largest U.S. brokers
Brokerage commissions	$4,639	$2,396	$2,202	$2,554	$11,790	$8,750
Underwriting and distribution	1,400	835	774	940	3,949	4,750
Net gain on trading	1,024	306	474	5	1,809	5,750
Interest and dividends	1,401	1,398	67	694	3,560	22,150
[illegible]	62	183	180	211	686	5,250
[illegible]	8,516	5,118	[illegible]	[illegible]	[illegible]	[illegible]
Compensation and benefits	1,088	623	564	719	2,986	14,230
Interest expense	781	1,088	194	408	2,471	21,175
[illegible]	2,016	1,094	1,048	1,118	5,276	9,985
[illegible]	3,885	2,805	[illegible]	[illegible]	[illegible]	[illegible]
Income before taxes	4,631	2,318	1,876	2,168	10,998	2,200
Nonoperating income & other	0	(39)	31	18	8	NA
Taxes	2,503	1,264	1,085	1,160	5,990	NA
[illegible]	2,128	1,026	[illegible]	[illegible]	[illegible]	[illegible]
Pretax margin²	60%	58%	54%	54%	56%	9%
Average shareholders' equity	6,950	3,413	3,287	3,197	16,846	19,000
Pretax return on equity	67%	67%	58%	68%	65%	12%

All figures in millions of dollars; prices have been rounded. ¹Financial statement excludes unconsolidated subsidiaries. ²Revenues include net interest. NA=Not available.

Source: Sanford C. Bernstein & Co.

2. Japanese brokerage houses are far more profitable than U.S. firms partly because of lower costs and partly because of higher commission income, which may reflect fixed rates.

Representative OBEY. Thank you very much.

Mr. Sachs, please proceed.

STATEMENT OF JEFFREY SACHS, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. SACHS. Thank you very much.

Please, I hope you'll forgive my hoarseness. I'm nursing a flu, but I hope it won't interfere with understanding my testimony.

It is a great pleasure to be here and I thank the committee very much for the invitation. The charge in our invitation was quite broad, and that was to discuss issues of international economic policy. There are literally a dozen which are pressing right now, including trade policy reform in Eastern Europe and behavior of the East Asian economies and so forth.

I am going to focus my remarks on a couple of issues and hope that we might come back to others of your interest in discussion. The two issues that I want to address myself to today are, first, the issue of the U.S. trade imbalance and prospects for the trade imbalance; and, second, the issue of developing country debt which I regard as being at a very critical juncture right now and one demanding the immediate attention of our Government.

These issues are at some level obviously distinct, but I would like to underscore that they are actually related at a deep level. The U.S. trade deficits right now in my view have a lot to do with the fact that we are behaving like the Latin American economies did at the end of the 1970's and early 1980's. And if we continue with what we're doing, not imminently but down the road, we're going to end up in a similar mess. And I think that's important to underscore.

When I hear, Congressman Upton, with all due respect, the idea that taxes are ruled out right at the beginning, I am very much reminded of my Latin American politician friends who make similar statements and made similar statements in the past 10 years. It's a favorite line in Latin America: We can't risk any slowdown of the economy right now; we can't do anything which might hurt the next 6 months or a year. And the result is a failure to consider the long-term future of the economy.

I would submit that we are failing to provide an adequate future right now by a view which rules out quite reasonable policies. We are, like Latin America, not saving for our future. At a time when the East Asian economies are saving 40 percent of GNP, we are saving in net terms 5 or 6 percent of GNP and our budget has a lot to do with that, and our taxes have a lot to do with our budget problems.

So I would urge that we not fall into a Latin Americanization of our policies and really start looking at a long-term responsible course which allows our government to pay its way, particularly to carry out our global responsibilities which I don't think we're dong right now, as I'll explain when I get to the debt crisis.

I want to touch on five points with respect to the trade balance. The first is the origins of the U.S. trade imbalance. Second is the role of macroeconomic policies in resolving the trade imbalance. The third is the prospect for a Latin American style hard landing of the U.S. economy. The fourth is the risk of treating symptoms of our trade balance right now rather than the fundamentals. And here I am particularly concerned with the hardening of our rhetoric vis-a-vis the East Asian economies, as if somehow they are doing great damage to us through Machiavellian manipulative policies, whereas I very strongly believe that the problem is in ourselves and our failure to save for the future. And the fifth point I want to make is a short-term risk right now, which in my view is not a hard landing in the very near future, but rather the inflationary consequences of failing to address the budget problem.

Now, on the origins of the trade imbalance, I just want to leave one very simple message for the committee. It's a message which I think policymakers understand increasingly but don't always act on. And that is that a trade imbalance is not primarily a symptom of trade policies either here or abroad, but rather is a symptom of savings-investment imbalances that are typically completely unrelated to trade policy.

The current account balance is the difference between national savings and national investment. Shifts in savings and investment rates through budgetary policy and macropolicies are the fundamental determinants of shifts in the current account balance. One is extraordinarily hard pressed to link the developments on the trade account to developments in trade policy.

For instance, we spend a lot of time bashing Korea and Taiwan right now about their trade policies. There is no doubt that they have liberalized substantially in the 1980's, at the very moment that our trade imbalances with them have become so bad. No question in the world that there has been extensive liberalization all through the 1980's. And yet, the trade imbalance has continued to worsen with them, and that is a surprise to the general public who naturally links the trade imbalances to allegations of closed markets and so forth abroad, but it should not be a surprise to a macroeconomist or a policymaker who should understand from the beginning that the trade imbalance is a measure of the excess of spending over income or, equivalently, the excess of investment over savings in the economy.

So I want to leave on major throught. Our trade problems reflect macroeconomic phenomena, not trade policy phenomena by and large. There are many interesting and important trade issues to deal with and I'm not happy with a lot of trade policies in Japan right now. But to focus on the trade imbalance as a reflection of those trade policies is to make a very fundamental analytical mistake.

There have been volumes of studies on the origins of our trade imbalances. Remember that we had a current account surplus not so long ago, back in 1980. So this was a rather sudden turnaround. There have been lots of studies at this point of where the trade imbalances came from, and I would point out four fundamental macroeconomic shifts that have taken place.

The first is the divergence of fiscal policies in the United States and the rest of the world. Japan and Germany contracted budget deficits. By the way, they did it by raising taxes just as much as cutting spending, and Japan has shown that that does nothing detrimental to long-term economic growth.

Second, the international capital markets have been liberalized, which is a very fundamental factor, particularly liberalized in Japan and in Europe, which is a fundamental reason why savings in those regions can now finance our low savings rates. All of this imbalance could not have happened and been sustained if Japan had kept the closed capital markets that it had up until 1980, and if the United Kingdom, France, Italy, and others had kept their capital markets cut off from ours through capital controls.

But, almost by coincidence, as we were embarking on Reaganomics, they were embarking on capital decontrol, so all of a sudden as our national savings rates plummeted, their savings became available to finance our low savings and sustain our investment rates. And that is a very important thing to keep in mind. I think it's almost historical accident. I don't see any really obvious and direct policy links there.

A third factor in our trade imbalance is the development of the Latin American debt crisis. These countries, the developing countries as a whole, were borrowing a great deal and, on that basis, were able to import more than they were exporting. We were financing a trade deficit of this region. When our banks stopped lending to these debtor countries, then they couldn't run those trade deficits anymore. They had to have an improvement in their trade balances and that meant, just as a mechanical feature, that the rest of the world had to have a worsening in their trade balance.

And so the emergence of the debt crisis in the early 1980's played a role in the worsening of our trade balance. The way that that's most easily said—perhaps I didn't make it as clear as possible—is that when we stopped financing their imports, our exports fell. And that's the way that it showed up here. But it's a mechanical feature of the world that if one region can't run as large trade deficits anymore because no one will lend to them to do it, then the rest of the world has to have smaller trade surpluses or larger trade deficits.

The fourth thing that's happened in the U.S. economy which macroeconomists do not have a good handle on is that the private savings rate has declined, in addition to the public savings rate. As our budget deficit got larger, so too did our private savings, household savings rates decline. And that's particularly true after 1985. I would add that as a fourth factor, even though that's not an exogenous shock. We don't understand what in the system really made that happen.

If I try to put those pieces together—I've done a number of studies myself and I am going to leave for the record a recent publication I did for the Brookings Institution on this.

[The publication follows:]

JEFFREY D. SACHS
Harvard University

Global Adjustments to a Shrinking U.S. Trade Deficit

SINCE EARLY 1985, when the U.S. administration began to encourage the depreciation of the dollar to reduce the U.S. trade imbalance, there has been considerable discussion of the need for international policy coordination to bring about a "soft landing" in the world economy. Two kinds of recessionary risks have been widely discussed. The first is that the United States will do little about its budget deficit, so that foreigners will be called on to provide significant financing for many years to come. If they become reluctant to lend, then U.S. interest rates could soar, causing the dollar to collapse, and pushing the United States into a recessionary balance-of-payments crisis.

The second recessionary risk starts from an almost opposite premise: that the United States will cut its budget deficit sharply, without a compensatory fiscal expansion abroad, and thereby throw the world into an aggregate demand slump. U.S. Treasury officials in the past three years have strongly urged more expansionary fiscal policies in Germany and Japan to avoid this outcome, and influential independent economists have concurred in this advice.

This paper examines the prospects for reducing the U.S. trade imbalance and the plausibility of the hard-landing scenarios. A review of evidence on the sources of the trade deficit finds that the U.S. budget deficit is the most important, but not the only major, source. Reducing the budget deficit would help to reduce the trade deficit, but even if the

This paper has benefited substantially from a collaborative research effort on simulation modeling of international macroeconomic interdependence with Warwick McKibbin of the Reserve Bank of Australia. The global simulation project is supported by grants from the World Institute of Development Economics Research (WIDER), in Helsinki, Finland, and from the Brookings Institution.

budget deficit were eliminated, a substantial trade deficit would remain. Equally important, an attempt to reduce the trade deficit further by a depreciating exchange rate induced by easier monetary policy would, at this stage, produce inflation with little benefit on the current account.

A second finding is that a hard landing caused by a withdrawal of investor confidence is implausible in the next few years, though certainly not impossible. The experience of the Latin American economies in the 1980s is proof enough that a crisis based on a loss of foreign confidence can indeed occur, but attempts to draw close analogies between the U.S. situation and that of Latin America are unconvincing. Furthermore, there is, at least as yet, little evidence of a rising risk premium on dollar assets. The evidence to date is that, for good or bad, the U.S. deficits can be financed abroad for some time yet without triggering steeply rising interest costs.

The third finding of the paper is that the global recessionary risks of fiscal tightening in the United States are overblown. Simulation exercises suggest that U.S. fiscal tightening need not be balanced by fiscal expansions abroad. Even though a U.S. fiscal contraction would tend to reduce the demand for European and Japanese exports, it would also reduce world interest rates, thereby spurring internal demand in Europe and Japan. On balance, the effects of U.S. budget cutting may well be expansionary on the rest of the world, and can almost surely be made so with accommodating monetary policy abroad. Indeed, the current "mini-boom" in Germany and Japan, in which growth during 1987–88 has been significantly higher than anticipated, would appear to show this mechanism at work.

Origins of the U.S. Trade Imbalance

General public opinion makes the fundamental mistake of viewing trade imbalances as a reflection of trade policies and trade distortions, rather than as a reflection of saving and investment behavior usually unrelated to trade policies. While there may be cases in which a change in trade policies can affect the trade balance (through indirect effects on saving and investment behavior), there is little reason to believe that growing trade or current account imbalances in the industrialized countries since the early 1980s have had anything to do with changes in trade policies in this decade.

Table 1. Current Account Imbalances, Industrial Economies, 1985–88

Economy	*1985* Billions of dollars	*1985* Percent of GNP	*1986* Billions of dollars	*1986* Percent of GNP	*1987* Billions of dollars	*1987* Percent of GNP	*1988*[a] Billions of dollars	*1988*[a] Percent of GNP
United States	−116.5	−2.9	−141.3	−3.3	−160.7	−3.6	−150	−3.1
Japan	49.2	3.7	85.8	4.4	87.0	3.6	85	2.9
Germany	16.2	2.6	37.9	4.2	44.3	3.9	47	3.8
G-7 countries[b]	−51.7	−0.7	−18.4	−0.2	−44.6	−0.4	−44	−0.4
Smaller European countries[b]	7.6	0.8	7.3	0.6	1.1	0.1	−5	−0.3
Total OECD[b]	−54.1	−0.6	−22.3	−0.2	−53.5	−0.4	−58	−0.4

Source: *OECD Economic Outlook*, no. 43 (June 1988), pp. 57–58, tables 28, 29, and 30.

a. Projections.

b. OECD reports country data as a percent of GNP or GDP depending upon conventional measurement within each country.

As ample research has stressed, three macroeconomic developments adequately account for the bulk of the current account imbalances shown in table 1. The first is the divergence of fiscal policies in the Organization for Economic Cooperation and Development economies, primarily the growth of U.S. fiscal deficits and the reduction of fiscal deficits in Germany and Japan; the second is the liberalization of international capital flows in several countries, especially Japan, in the early 1980s; and the third is the cutoff in lending to the debtor developing countries, which forced a reduction in the trade deficits in the debtor countries, and thereby resulted in greater trade deficits in the rest of the world.

Nuriel Roubini and I used a multicountry simulation model to make a rough assessment of the quantitative role of these factors in accounting for the changes in trade imbalances in the United States and Japan between 1978 and 1985.[1] The effects of the U.S. trade balance, the Japanese trade balance, and the yen-dollar real exchange rate are shown in table 2. For each variable, the actual change shown records the 1985 value relative to its average value during 1978–80. Between 1979 and 1985, OECD estimates of the U.S. inflation-adjusted structural budget deficit increased by 4.4 percent of U.S. GNP; the Japanese full-employment budget deficit decreased by 3.7 percent of GNP; and the full-employment budget deficit in the rest of the OECD decreased by 0.5 percent of GNP. External net lending to the nonoil developing countries

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[1] Jeffrey D. Sachs and Nuriel Roubini, "Sources of Macroeconomic Imbalances in the World Economy: A Simulation Approach," Working Paper 2339 (National Bureau of Economic Research, August 1987).

Table 2. Decomposition of Changes in the External Balance and Bilateral Exchange Rate, United States and Japan, 1978–80 through 1985
Percent

			Decomposition of predicted change				
			Fiscal policies				
Variable	*Actual change*[a]	*Predicted change*[b]	*United States*	*Japan*	*Rest of OECD*	*LDC lending*	*Monetary policies*
U.S. trade balance[c]	−1.9	−1.8	−1.0	−0.2	−0.0	−0.4	−0.2
Japanese trade balance[c]	3.2	2.8	1.4	1.9	−0.1	−0.6	0.3
U.S.-Japan real exchange rate[d]	24.0	28.0	11.8	10.6	−0.0	−0.1	6.6

Source: Jeffrey D. Sachs and Nuriel Roubini, "Sources of Macroeconomic Imbalances in the World Economy: A Simulation Approach," Working Paper 2339 (National Bureau of Economic Research, August 1987). Original data from OECD National Income Accounts.

a. The actual changes measure the 1985 value of the variable compared with the average value of the variable during 1978–80.

b. The predicted changes come from a simulation of the McKibbin-Sachs model (2), described in the source, based on changes in fiscal policies in the United States, Japan, and the rest of the OECD of the historically observed magnitudes; an exogenous reduction in lending to the LDCs; and offsetting monetary policies in the industrial countries.

c. The trade balance is measured as a percentage of GNP.

d. The real exchange rate measures the percentage change in the relative consumer price indexes of the United States and Japan, corrected for changes in the nominal exchange rate. The positive value signifies a real appreciation of the U.S. dollar.

dropped, after 1982, by approximately 1.4 percent of U.S. GNP, a development that is taken to be exogenous in the simulation exercise.

We see from the table that the U.S. trade balance worsened by 1.9 percent of U.S. GNP during this period, while the model predicts a deterioration of 1.8 percent of GNP based on the four changes just mentioned. Just over half the change in the U.S. external position (1.0 percent of GNP) is attributed to the growth in the U.S. fiscal deficit; another 0.2 percent is attributed to the Japanese fiscal contraction; and another 0.4 percent of GNP to the LDC lending cutoff. Finally, another 0.2 percent is ascribed to the combined effects of monetary policy changes in each of the regions in the model.[2] In the case of the Japanese trade surplus, which rises by 3.2 percent of GNP, the model predicts an improvement of 2.8 percent based on the fiscal and monetary policy changes, of which 1.9 percent is ascribed to the Japanese fiscal contraction, and 1.4 percent to the U.S. fiscal expansion.

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[2] The underlying monetary policy assumed in the simulation exercise is that monetary policy leans against fiscal policy to keep an overall macroeconomic balance. In the United States, tight monetary policy during 1978–85 balances the expansionary fiscal policy; in Japan and the rest of the OECD, loose monetary policy balances the effects of the tight fiscal policy. In any event, monetary policy has little effect on the external balance, a point to which I shall return, though monetary policy has an important effect on the level of internal economic activity and on the overall level of exports and imports (but not on exports minus imports).

Capital market liberalization, especially in Japan after 1980, comes into these estimates indirectly. Without the liberalization of Japanese capital movements the Japanese trade imbalances would not have been sustained. The Japanese fiscal contraction for the same period, for example, would have reduced domestic interest rates in Japan, thereby inducing an increase in Japanese domestic investment (and perhaps a fall in private saving), rather than a capital outflow and a trade surplus. The yen would not have experienced its 24 percent real depreciation between 1978–80 and 1985.

The estimates in table 2 examine the changes in external balances between 1978–80 and 1985. Between 1985 and 1988, the U.S. external balance turned even more negative (fairly sharply in 1986 and 1987, before improving slightly in 1988). It would seem that these subsequent changes cannot be well explained by fiscal policy changes after 1985, since the U.S. budget deficit has declined as a percentage of GNP while the external deficit has grown. As in the first half of the 1980s, there is no evidence that shifts in trade policy, either actual or anticipated, in the United States or abroad played a role. As an accounting matter, the current account deficit (equal to national investment minus national saving) deteriorated further because private saving, mainly household saving, fell sharply, even as public saving increased (that is, became less negative). The household saving rate fell from an average of 6.8 percent of disposable income during 1980–84 to 3.9 percent of disposable income in 1987.[3]

Some of the decline in the private saving rate might be an endogenous response to macroeconomic policy. For example, private saving might have declined to some extent because of the fall in interest rates and rising stock market values after 1985, which in turn resulted in part from expansionary monetary policy and tightening fiscal policy. It seems, however, that much of the decline cannot easily be accounted for in these terms.[4] In any event, this fall in private saving rates seems to have contributed to the recent deterioration of the external balance above and beyond the contribution of the budget deficit.

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[3] Data are from *OECD Economic Outlook*, no. 43 (June 1988), table R12, p. 181.

[4] See Lawrence Summers and Chris Carroll, "Why Is U.S. Saving So Low?" *BPEA, 2:1987*, pp. 607–45, for a detailed description of the puzzling decline in private saving, as well as the general inability of standard explanations to account for it.

Budget Deficit Reductions and the External Balance

The data in table 3 provide further general evidence that fiscal policy changes have been important, but not one-for-one, determinants of the shifts in external imbalances since the late 1970s. Countries with growing budget deficits after 1979 experienced, on average, larger current account deficits. Since the current account equals national saving minus national investment, which in turn equals the financial balance of the government (government saving minus government investment) plus the financial balance of the private sector (private saving minus private investment), changes in the government financial imbalance will translate into current account changes if the private saving-investment balance remains unchanged. In general, the private balance will respond *partially* to offset changes in the public sector balance, but in general the offset will be less than complete.[5]

A simple regression of the change in the current account position on the change in fiscal balance, using the data of table 3, suggests that a budget deficit increase of 1.0 percent of GNP was associated, on average, with a deterioration of the current account of 0.66 percent of GNP. With CA the current account surplus (and $-CA$ the deficit), and D the financial deficit of the public sector, we have

$$d(-CA/GNP) = \underset{(1.15)}{0.72} + \underset{(2.91)}{0.66}\, d(D/GNP),$$

$$R^2 = 0.55,$$

with $d(-CA/GNP)$ and $d(D/GNP)$ referring to the changes of the variables for the average of 1985–86 relative to the average of 1978–79. While the offset coefficient of 0.66 should not be taken as a structural

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[5] Of course, in the theory of Ricardian-Barro equivalence, some kinds of changes in the public sector balance are predicted to lead to exactly offsetting changes in the private sector balance. For example, a cut in current taxes that leads to larger current budget deficits and higher future taxes is hypothesized to increase private saving as households anticipate larger future tax liabilities. In effect, households fully save, rather than spend, the increased income resulting from the tax cut, in anticipation of their future tax liabilities.

Table 3. Changes in General Government Financial Balances and Current Account Imbalances, Industrial Countries, 1978–86[a]
Percent of GNP

Country	*Change in government financial balance*	*Change in current account*
United States	−3.65	−2.75
Japan	4.15	3.65
Germany	1.32	3.05
France	−1.60	−0.97
United Kingdom	0.95	0.30
Italy	−1.90	−2.00
Canada	−3.70	0.85

Source: *OECD Economic Outlook*, no. 43, tables 30, R13, and R20, pp. 58, 182, 189.

a. The change in the government financial balance measures the change in the ratio of the general government financial balance as a percentage of GNP or GDP. The change is calculated as the average value of the ratio for the years 1985–86, minus the average value for 1978–79. The change in the current account is measured similarly.

estimate (especially since the offset is likely to differ across countries), the equation clearly highlights the statistical correlation between shifts in budget policy and shifts in the external balance in the past decade.

In the simulation model underlying table 2, a sustained, bond-financed U.S. fiscal expansion (an increase in federal spending on goods and services) worsens the U.S. trade balance in the year of the expansion by 0.34 percent of GNP and by an average of 0.31 percent of GNP over three years, with a third-year effect of 0.29 percent of GNP. Large-scale macroeconometric models give diverse estimates of the offset in the case of the United States, but the estimate of 0.31 is in the middle of the range. Table 4 shows the estimated effects of a fiscal expansion in four popular models of international macroeconomic interdependence. The third-year effect ranges from 0.51 percent of GNP to 0.29 percent, with an unweighted average effect of 0.40 percent of GNP. While these estimates have a moderate dispersion (and reflect the professional uncertainties on this subject), they all show a trade-off of about 0.5 or less.

Thus, the fall in public saving is matched by a rise in private saving, with no overall change in the current account balance. I do not adopt this view, consistent with a considerable body of negative theoretical and empirical evidence. For a critical survey of the theory, see B. Douglas Burnheim, "Ricardian Equivalence: An Evaluation of Theory and Evidence," in Stanley Fischer, ed., *NBER Macroeconomics Annual, 1987* (MIT Press, 1987).

Table 4. Simulations of Effect of U.S. Fiscal Expansion on U.S. Current Account[a]
Percent of GNP

Model	Year 1	Year 3
Japanese Economic Planning Agency World Model	−0.08	−0.40
Federal Reserve Multicountry Model	−0.37	−0.51
Organization for Economic Cooperation and Development Interlink	−0.37	−0.39
McKibbin-Sachs Global Model (2)	−0.34	−0.29

Source: For the first three models, John F. Helliwell, "The Effects of Fiscal Policy on International Imbalances: Japan and the United States," Working Paper 2650 (National Bureau of Economic Research, July 1988, table 4); for the McKibbin-Sachs Global Model (2), Sachs and Roubini, "Sources of Macroeconomic Imbalances in the World Economy."

a. The table measures the effect of a 1 percent of GNP increase in fiscal expenditure on goods and services, on the current account as a percent of GNP. (In the case of the McKibbin-Sachs model, the effect is measured for the trade balance rather than the current account balance.)

There are several reasons for the less than one-for-one link between changes in the budget deficits and changes in the trade balance.[6] Basically, a tightening of fiscal policy (taken here to be a cut in government spending with unchanged tax policy, and thus lower bond-financed budget deficits) induces a rise in private investment rates and a fall in private saving rates. Private investment increases as lower budget deficits lead to a reduction of interest rates and a crowding-in of investment. Private saving rates fall for cyclical reasons. The decline in government spending also leads to a temporary decline in national income (relative to a baseline path). Since households perceive the output decline as temporary, they temporarily reduce their rate of saving in response to the reduction of output, in order to smooth the path of consumption. Overall, therefore, the effect of higher government saving on the current account is partially offset by a fall in private saving and a rise in private investment.

The fairly modest effect of fiscal policy on the current account deficit has an important implication consistent with the findings of table 2. The U.S. fiscal expansion was only *one* of the reasons for the widening of the U.S. current account deficit. Completely *eliminating* the U.S. budget deficit, other things being equal, would remove no more than half the current external gap. During 1987:2–1988:2 the current account deficit was 3.6 percent of GNP; the fiscal deficit, 3.4 percent of GNP. Applying a coefficient of 0.40 (the average of the four models reported in table 4) to the effect of the budget deficit on the current account deficit means that closing the budget deficit would reduce the external deficit from 3.6 percent of GNP to approximately 2.2 percent of GNP, or to about $100 billion in 1988.

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[6] Of course, the observed linkages between budget deficits and the trade balance will depend on the precise nature of the fiscal policy changes that are undertaken. For example, the effect of changes in bond-financed government spending on the trade balance will depend on whether the spending changes are perceived to be temporary or permanent, since the expected duration of the change will affect how households perceive the change in their own lifetime budget constraints in light of the fiscal policy measures.

Balancing the U.S. current account will therefore require policy actions or other economic events (for example, a strong recovery of household saving) beyond balancing the U.S. budget. Fiscal policies in other countries are unlikely to make a big difference. The effects of foreign fiscal actions on the U.S. external balance are small (as table 2 shows, a 3.7 percent fiscal contraction in Japan between 1978 and 1985 worsened the predicted U.S. current account deficit by only 0.2 percent of GNP). Moreover, the fiscal contractions in Germany and Japan during the 1980s are unlikely to be reversed. The initial fiscal conditions in Germany and Japan at the end of the 1970s were at the time widely regarded as having been undesirable and unsustainable, and there is little interest now in returning to those larger deficits.[7]

In conclusion, while the U.S. budget deficit is a central factor in the large current account deficit, even its complete elimination, however unlikely, would not by itself restore external balance in the United States. At the core, the U.S. external imbalance is a structural feature of the U.S. economy also reflecting the extraordinarily low net saving rate in the private sector, and particularly in the household sector, combined with sufficiently favorable investment prospects to induce a continuing inflow of foreign capital.

The Exchange Rate and the External Deficit

So far I have focused on the saving-investment balance in interpreting the U.S. current account imbalance, attributing the external deficit to the low saving rate, which in turn results from large budget deficits combined with a chronically low and declining private saving rate. How does this interpretation square with the conventional view that it was the strong dollar during 1980–85 that caused the large trade deficits, and that a weak dollar now will make the trade deficit disappear?

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[7] In Japan, the general government financial balance in 1979 was a deficit of 4.7 percent of GNP (significantly larger than the current U.S. budget deficit), and the German deficit was 2.5 percent of GNP. In both countries, the ratio of public net debt to GNP had risen sharply in the late 1970s, to the considerable concern of policymakers in both countries. See *OECD Economic Outlook*, no. 43 (June 1988), table R13.

The answer is that the dollar exchange rate is an endogenous variable and therefore cannot be considered a cause of movements in the trade balance. As shown later, the dollar appreciated in the early 1980s because of high U.S. interest rates, which were in turn caused by the large U.S. fiscal deficits coupled with tight monetary policy.[8] It was the monetary-fiscal mix that was behind *both* the appreciation of the dollar and the rising external deficits. Similarly, a change in policy mix since 1985 (easier money, combined with some actual and some anticipated tightening of fiscal policy) can explain much of the subsequent depreciation of the dollar.

Stressing the more fundamental role of fiscal policy for the movement both of the exchange rate and of external balance helps avoid one fallacy common in policy discussion. It is sometimes suggested that the United States needs only a further fall of the dollar to balance its external accounts; *how* that decline in the dollar is to be brought about is left unspecified. But the source of the dollar decline is crucial in assessing how it would affect the development of the trade balance. To the extent that the dollar depreciates because of tighter fiscal policy, the effect would be a further improvement in the trade balance (on the order of 0.4 times the change in fiscal policy). By contrast, to the extent that the dollar depreciation is induced by a monetary expansion, the benefits for the trade balance would be much smaller, and perhaps nonexistent.

Consider what happens to the trade balance if the Federal Reserve eases monetary policy to drive the dollar lower. A monetary expansion causes the domestic interest rate to decline and induces an incipient capital outflow, causing the dollar to depreciate. The weaker dollar boosts exports and thereby GNP (assuming initial excess capacity), which in turn causes national saving to rise (since household consumption

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[8] A fiscal expansion induces a dollar appreciation by causing domestic interest rates to rise, thereby inducing an incipient capital inflow, as wealthholders attempt to shift out of foreign assets to buy higher-yield domestic assets. The dollar then appreciates until the point where the interest rate differential between the United States and abroad is just balanced by an expected future depreciation of the dollar.

Table 5. Simulations of Effects of U.S. Monetary Expansion on the Effective U.S. Exchange Rate and U.S. Current Account[a]

Model	*Current account (change as percent of GNP)*		*Nominal exchange rate*[b] *(percent change)*	
	Year		*Year*	
	1	*3*	*1*	*3*
Japanese Economic Planning Agency World Model	−0.02	0.02	−1.0	−1.7
Federal Reserve Multicountry Model	−0.03	−0.01	−1.7	−1.5
Organization for Economic Cooperation and Development Interlink	−0.11	0.01	−0.9	−0.6
McKibbin-Sachs Global Model (2)	−0.00	0.01	−1.4	−1.1

Source: For the first three models, see Ralph C. Bryant and others, "Estimates of the Consequences of Policy Actions," in Ralph C. Bryant and others, eds., *Empirical Macroeconomics for Interdependent Economies* (Brookings, 1988), tables 4-15 and 4-16, pp. 78–79. The original data for the current account record the change in absolute billions of dollars, rather than as a percent of GNP. The conversion is made using a baseline value of GNP of $3,900 billion (1985 value) for year 1, and $4,400 billion for year 3. For the McKibbin-Sachs Global Model (2), see Sachs and Roubini, "Sources of Macroeconomic Imbalances in the World Economy," table 7. (The nominal exchange rate must be calculated from the table, using the reported values of the real exchange rate and the inflation rate.)

a. The table records the effect of a permanent 1 percent increase in the U.S. money supply (M1) on the current account (change as percent of baseline GNP) and on the exchange rate (percent change).

b. Negative sign signifies depreciation.

will rise less than the temporary, money-induced increase in output). At the same time, the lower domestic interest rates will cause domestic investment to rise.

Because the external balance will change according to the rise of saving minus the rise of investment, a weaker dollar brought about by a monetary expansion has an ambiguous effect on the trade balance. Both saving and investment tend to rise, and the trade balance may either improve or worsen. Put in more conventional terms, the weaker dollar resulting from the monetary expansion induces a rise in exports, but it also causes a rise in imports, since domestic spending is increased by lower domestic interest rates.

Table 5 reports the effects of money expansion on the exchange rate and trade balance in the same simulation models reported in table 4. The point of this section is strongly borne out: while a monetary expansion is predicted to lead to a dollar depreciation in each of the models, the effect on the trade balance is generally small, and actually negative in the first year, and of ambiguous sign in the third year. In the Multicountry Model of the Federal Reserve Board Staff, the dollar depreciation is associated with a worsening in the current account balance by the third year, while in other models it is associated with an improvement. The overall message is crucial, but not widely understood. Driving down the dollar through a low-interest *monetary* policy improves the trade balance little, if at all.

As I will point out later, much of the decline in the dollar since 1985 has resulted from a combination of easy monetary policy and the expectation of tighter fiscal policy, rather than from an actual tightening of fiscal policy. This point helps to explain why the improvement in the external trade balance has been so modest, despite the sharp depreciation of the dollar.

The U.S. current account deficit has declined from approximately 3.3 percent of GNP in 1986 to an estimated 3.1 percent of GNP in 1988. The part of the depreciation due to monetary expansion has led to rapid growth, but little improvement in the trade balance. The part due to an actual cut in the fiscal deficit has been small. With the fiscal deficit having declined by about 1.5 percent of GNP between 1986 and 1988, the estimated trade balance effect is predicted to be only about 0.4 × 1.5 percent of GNP, or about 0.6 percent of GNP, or slightly larger than the current account gains to date.

Will Foreign Investors Close the External Deficit?

One theme of the hard-landing school is that if the U.S. fiscal authorities do not close the budget deficit sufficiently to balance the external deficit, the external creditors of the United States will close the external deficit for us, by reducing the inflow of foreign capital.[9] The concern is that such a cutoff in lending would likely be disorderly, causing a large jump in interest rates and a sharp fall of the dollar, thereby provoking a recession in the United States, combined with a jump in inflation following the collapse of the currency. Many commentators in the past two years have viewed the steep depreciation of the dollar that has already occurred as the first manifestation of the feared hard landing.

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[9] This risk has been stressed by Stephen Marris, *Deficits and the Dollar: The World Economy at Risk,* Policy Analyses in International Economics no. 14 (Washington, D.C.: Institute for International Economics, 1985); and by Martin Feldstein, "The Stock Market Decline and Economic Policy," testimony to the Banking Committee of the U.S. House of Representatives, October 29, 1987.

But while the theoretical possibility of this kind of crisis clearly exists, a quantitative assessment of the risks shows that such fears are exaggerated, at least for the next few years.

The theoretical case is straightforward. A current account deficit depends on the availability of foreign financing. With a zero net capital inflow, no external current account deficit is possible. In the event that foreign creditors stop lending to U.S. residents, the U.S. residents can continue to run current account deficits only so long as they can run down accumulated gross assets—assets held abroad and official foreign exchange reserves. Eventually, as the gross asset stock is reduced, the current account must come into balance, and even move into surplus if an amortization of foreign liabilities is required by the foreign creditors (and if there is no default on these obligations).

Assuming that the budget deficit remains large, the cutoff in foreign lending leads to a sharp increase in domestic interest rates, until the private net financial position ($S^P - I^P$) rises sufficiently, through lower investment spending and higher saving, to finance the budget deficit entirely out of surplus private domestic funds. The cutoff in foreign funds thereby converts the effect of the budget deficit from one of *external* crowding out (deterioration of the current account deficit) to the traditional closed-economy case of *internal* crowding out of investment.

At the moment that the foreign inflow ceases, there is a steep drop in demand for domestic goods and a sharp real dollar depreciation, in the sense both of a reduction in the price of domestic goods relative to foreign goods and of a reduction in the price of nontradable goods relative to tradable goods. It is likely that the collapse in internal demand caused by the rise in domestic interest rates will lead to unemployment. Workers laid off by the declining nontradables sector are unlikely to be absorbed instantly into export and import-competing sectors.[10] Part of the adjustment mechanism of the sudden balancing of the current account, therefore, is likely to be a steep drop in domestic output and a rise in unemployment.

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[10] There are several reasons why the adjustment process is likely to result in a transitional period of (perhaps high) unemployment. The sudden drop in internal demand requires a reallocation of resources from nontradables production to tradables production. This resource reallocation generally requires a fairly sharp drop in real wages to induce the tradables sector firms to hire the labor laid off by the nontradables sector. Assuming any form of real wage resistance (or nominal wage rigidity combined with a monetary authority resisting internal inflation), the result will be a rise in unemployment.

The case of Mexico in 1982–83 is a classic example of a hard landing. (Almost any Latin American country in the 1980s would serve the purposes of illustration.) During 1979–82, the Mexican government ran enormous budget deficits, reaching 14 percent of GDP in 1981, on the eve of the crisis.[11] These deficits contributed to large current account deficits of more than 5 percent of GDP in 1981. Through the combination of a steep rise in world interest rates, weakening oil prices, and growing skepticism over Mexican fiscal management, private foreign investment shifted remarkably from a net capital inflow of medium- and long-term funds of $11.5 billion in 1981, to $6.1 billion in 1982, and only $2.7 billion in 1983. Mexico tried to roll over existing debts in the spring of 1982, but found itself unable to attract the desired loans. It announced in the summer of 1982 that it would therefore be unable to meet its principal obligations in the short run, and that announcement in turn provoked a virtually instantaneous and complete withdrawal of new credits.

The cutoff in foreign lending had the expected effect. The current account moved from a deficit of $6.2 billion in 1982 to a surplus of $5.3 billion in 1983.[12] The currency collapsed, inflation accelerated sharply, and Mexican GNP declined 5 percent in real terms in 1983.

Is the United States Next?

The plausibility of the hard-landing scenario is often argued on the basis of three observations. First, the U.S. fiscal and external positions are serious enough to generate profound external concern and reticence to lend. Second, even if the budget deficit is not large relative to U.S. GNP, the foreign financing required (currently $150 billion a year) is large relative to the rest of the world. Third, the sharp fall of the dollar since its peak in 1985 shows the dwindling of the foreign appetite for dollar-denominated assets. All three arguments are dubious.

[11] The data and descriptions for Mexico are based on Ed Buffie, "Economic Policy and Foreign Debt in Mexico," forthcoming in Jeffrey Sachs, ed., *Developing Country Debt and Economic Performance: Country Studies* (University of Chicago Press, 1989).

[12] The surplus resulted from the fact that the Mexican monetary authorities accumulated foreign exchange reserves in 1983, raising them from a totally depleted level in the summer of 1982.

Analogies between the United States and Latin America are misleading. The U.S. situation, for example, differs significantly from that of Mexico in 1981. The Mexican current account deficit was more than 5 percent of GNP, compared with a U.S. current account deficit this year of about 3 percent of GNP. More importantly, the Mexican terms of trade were deteriorating sharply as a result of the fall of oil prices in 1982, thereby causing a sharp deterioration of the trade balance and the budget deficit. The Mexican net-debt-to-GNP ratio (measured as gross external debt minus foreign exchange reserves) was on the order of 50 percent of GNP, compared with the U.S. net foreign investment position at the end of 1987 of around 8 percent of GNP.[13]

Perhaps most important, the net indebtedness of the Mexican public sector was increasing rapidly. The public sector deficit in 1981 was on the order of 14 percent of GNP, and the inflation-adjusted deficit was on the order of 11 percent of GNP, which was leading to an explosion of the ratio of public sector debt to public sector revenue.[14] On the prevailing policy path of 1981–82, it was evident that the Mexican public sector could experience profound financial distress.

In the United States, on the contrary, the net indebtedness of the public sector has approximately stabilized as a percentage of GNP, and as a percentage of annual government revenues, even on a projection of continuing budget deficits of about $150 billion a year for the next five years. According to the Congressional Budget Office outlook as of February 1988, the federal debt held by the public reached 43.0 percent of GNP in 1987 and is projected to reach 43.4 percent of GNP in 1993 under current budget policy. The reason for the stability in the ratio should be clear. With nominal GNP projected to grow about 6.5 percent a year, the nominal debt itself can grow at the same rate without an increase in the debt-GNP ratio. Since the federal debt was 43 percent of GNP in 1987, it can grow each year by 2.8 percent of GNP (6.5 × 0.43), or about $130 billion in 1988, without an increase in the debt-GNP ratio. Since the deficit after 1990 is projected to be somewhat less than 2.8 percent of GNP, the projected ratio of debt to GNP begins to fall very slightly after 1990.[15]

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[13] It is probably true, however, that standard ways of reporting the net debt positions of the United States and of Latin America overstate the differences between the regions. The Mexican net debt position reported in the text does not count the net foreign assets of the Mexican private sector that were accumulated through heavy capital flight in the late 1970s and early 1980s, while the U.S. net foreign investment position does (in principle) count the net foreign assets of U.S. residents abroad. Buffie, "Economic Policy and Foreign Debt in Mexico," makes a rough correction of this problem, by measuring Mexico's net debt as the cumulative dollar value of current account deficits for Mexico. On this alternative measure, Mexico's net international indebtedness at the end of 1982 was on the order of $52 billion (rather than a conventional measure of net debt of around $87 billion), or about 30 percent of GNP. There is also a long and complex debate over the accuracy of the U.S. data. On the one side, U.S. assets held abroad are probably understated (thus exaggerating the U.S. net debt position), since foreign direct investment is valued at historical cost rather than market value. On the other hand, there are surely large unreported foreign holdings of assets in the United States (thus understating the U.S. net debt position), as evidenced by the errors and omissions account of the U.S. balance of payments during the past decade.

[14] The inflation-adjusted deficit measure subtracts from the conventional deficit measure the inflation component of interest payments on the internal debt. The calculation for Mexico was made by Buffie, "Economic Policy and Foreign Debt in Mexico," table 5.9.

Thus, the burden of the external indebtedness of the United States, and of the public debt, is under broad control compared with the explosive situation in Mexico and many other Latin American countries in 1982. But the argument is sometimes made that even if the external and internal debt and deficits are manageable relative to U.S. GNP, the amounts of foreign financing implied by the current situation are nonetheless too large from the point of view of the world economy. Will the world continue to lend the United States $150 billion a year without demanding a sharp increase in interest rates?

Skeptics point out that the implied capital flows are far larger, relative to the size of the world economy, than anything experienced in the past 30 years. But the historical record is misleading on this point. Until the 1980s, capital controls were sufficiently extensive to bar a sustained capital transfer among the industrial countries. Effective controls were in place in Japan, the United Kingdom, France, Italy, and most of the smaller European countries. By 1987, most controls had been eliminated. Moreover, the European community is now committed to complete internal capital market liberalization by 1992, which, when combined with the free international capital mobility in the largest European countries, will effectively integrate the entire European Community in the world pool of savings.

Table 6 shows the U.S. budget and current account deficits as a percentage of a conservatively estimated pool of saving and income that

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[15] See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1989–1993* (Government Printing Office, February 1988), table II-1, p. 50.

Table 6. U.S. Budget and Current Account Deficits relative to Foreign Saving and Income, 1987
Billions of dollars except as noted

Item	*Gross national saving*	*Gross domestic product*
Japan	774	2,375
European Community	822	3,928
Total	1,596	6,303
U.S. budget deficit as percent of total	9.5	2.4
U.S. current account as percent of total	9.6	2.4

Source: OECD National Income Accounts. Yen figures converted to dollars using average annual exchange rate as reported in the International Monetary Fund, *International Financial Statistics*.

ignores OPEC savers and includes only Japan and the European Community. In flow terms, the 1987 U.S. external deficit was 9.6 percent of the combined annual saving of Japan and the European Community. While financing the U.S. budget deficit and external deficit is not necessarily a desirable use of world savings, it would seem at least to be a feasible option.

Interpreting the Decline in the Dollar

The viewpoint just presented is optimistic about the ability of the United States to finance its external deficits in the next few years. An important competing view holds that the decline of the dollar in recent years is itself grounds for pessimism. Martin Feldstein, among others, contends that the decline of the dollar has resulted from the increasing reluctance of foreigners to hold dollar-denominated claims, which has therefore reduced the private capital inflows into the United States, causing a sharply falling dollar.[16] In this interpretation, sharply rising interest rates will be needed to encourage the requisite flows of capital from abroad, unless the U.S. budget deficit is decisively cut.[17] Without a sudden hard landing, as in Mexico, there will at least be a progressive reduction in domestic demand through an escalation of real interest rates.

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[16] Feldstein, "Stock Market Decline."

[17] Marris, *Deficits and the Dollar*.

To examine this argument, let us begin with a simple model of exchange rate determination.[18] Let r be the expected real interest rate on a default-free one-period dollar-denominated bond, and let r^* be the expected real interest rate on a one-year foreign-denominated bond. Let P and P^* be the domestic and foreign price levels, and let p and p^* be the logarithms. Thus, $r = i - (p^e_{t+1} - p_t)$ and $r^* = i^* - (p^{*e}_{t+1} - p^*_t)$, where $(p^e_{t+1} - p_t)$ is the expected inflation of the domestic prices. The real exchange rate, X, is defined as EP^*/P, where E is in units of dollars per unit of foreign currency. Let x and y be the logarithm of the real and nominal exchange rate, respectively. Note that a rise in x is then a real depreciation of the dollar. Let x^e_n be the expected value of x in n years.

Assuming risk-neutral foreign investors, interest arbitrage across national borders requires

$$(1) \qquad (y_{t+1})^e = y_t + i_t - i^*_t.$$

Using the definition of real interest rates, and the fact that $x_{t+1} - x_t = y_{t+1} - y_t + (p^*_{t+1} - p^*_t) - (p_{t+1} - p_t)$, yields

$$(2) \qquad (x_{t+1})^e = x_t + r_t - r^*_t.$$

Summing over equation 2 for periods t until $t + n$ yields

$$(3) \qquad (x_{t+n})^e = x_t + n\,(r^e_n - r^{*e}_n),$$

where r^e_n is the n-period expected real interest rate, expressed as an annual yield, as of time t. To get from equation 2 to equation 3, I use the assumption of risk neutrality and rational expectations to write the n-period yield as the average of the expected yields on the one-period bonds between time t and time $t + n$.[19]

The model is completed by assuming that n is large enough (say five to ten years), so that by n years the real exchange rate is expected to be

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[18] See Jeffrey D. Sachs, "The Dollar and the Policy Mix: 1985," *BPEA, 1:1985*, pp. 117–47; and Peter Hooper and Catherine Mann, "The U.S. External Deficit: Its Causes and Consequences," in *The U.S. External Deficit: Causes, Consequences, and Cures*, Proceedings of the twelfth annual economic policy conference, Federal Reserve Bank of St. Louis (Boston: Kluwer Academic Publishing, forthcoming, 1989).

[19] Specifically,

$$r^e_n = \frac{1}{n}\sum_{i=0}^{n-l} r_{t+l},$$

and similarly for r^{*e}_n.

back at its equilibrium level. Suppose further that the expected equilibrium level of x is a *constant*, x^c. For example, as Paul Krugman has recently argued on both theoretical and empirical grounds, the real exchange rate might return in the long run to a given rate based on purchasing power parity considerations.[20] Then, equation 3 can be written as

$$x_t = x^c - n\,(r^e_n - r^{*e}_n). \tag{4}$$

Now suppose that a divergent macroeconomic policy mix between the United States and the rest of the world leads to a rise in the interest rate differential of, say, 6 percentage points (as was the experience between 1978 and 1984), and say that n is six years. Then, equation 4 would predict that the 6 percentage point rise in the interest differential in favor of the United States would cause a dollar appreciation of 36 percent.

This view of determinants of exchange rates therefore stresses the importance of *long-term* real interest rate differentials and the long-term constancy of the real exchange rate. In turn, it is macroeconomic policies (for example, the expansionary U.S. fiscal policy combined with the contractionary Japanese fiscal policy) that contribute to the shifting interest rate differential. This simple model does remarkably well in accounting for the overall movement of the dollar in the past decade, as shown in figure 1.[21]

The figure shows the real interest rate differential of the United States and a weighted average of other countries, together with the movement in the log of the real exchange rate of the dollar vis-à-vis those other currencies.[22] (The figure uses $-x = p - e - p^*$ on the exchange rate axis, so that a rise in the index signifies a real appreciation.) The real interest rate for each country is calculated simply as the long-term rate minus the CPI inflation rate of that month over the same month the

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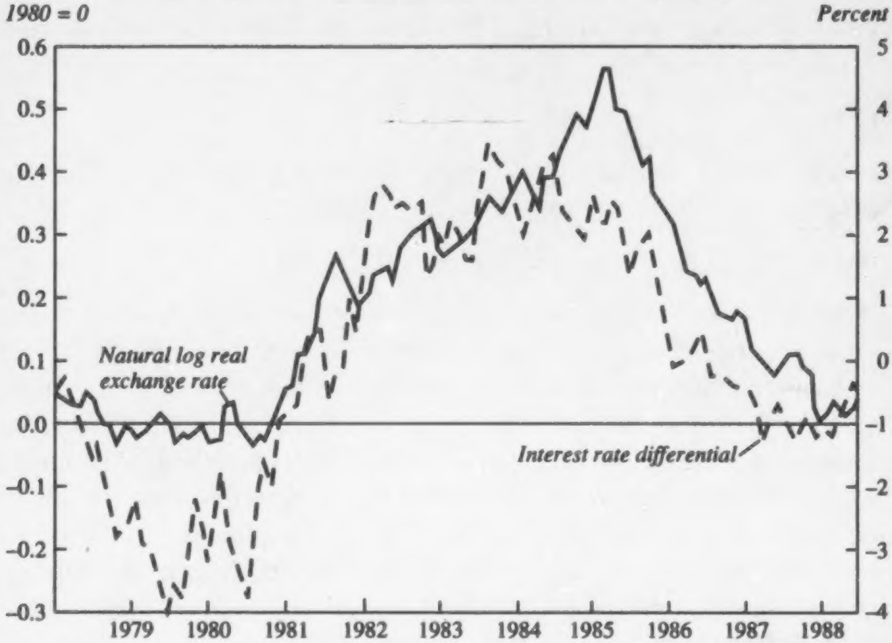
[20] See Paul Krugman, "Differences in Income Elasticities and Secular Trends in Exchange Rates," presented at the International Seminar on Macroeconomics of the National Bureau of Economic Research, in Tokyo, June 1988, and forthcoming in the *European Economic Review*.

[21] The figure updates a diagram in Hooper and Mann, "U.S. External Deficit."

[22] The index is a weighted average of eight major countries for which up-to-date data are available. The weights are determined by the share of the countries in the total trade (exports plus imports) of the group in 1980. The countries and weights are: Austria, 0.029; Canada, 0.091; France, 0.163; Germany, 0.254; Italy, 0.123; Japan, 0.089; Netherlands, 0.098; United Kingdom, 0.154.

Figure 1. The Dollar and the Real Interest Rate Differential, 1978:1–1988:6[a]



a. Real interest rates calculated as the long-term rate minus the CPI inflation rate of that month over the same month of the previous year. Differential measured between the United States and a weighted average of other countries.

previous year. The scaling of the diagram is such that each 1 percentage point interest rate differential corresponds to a 6.6 percent real exchange rate movement ($n = 6.6$).[23] Clearly, the rise in the dollar between 1980 and early 1985 corresponds to a sharp increase in the real interest rate differential in favor of the United States, while the fall of the dollar corresponds to an elimination of the interest rate differential between 1985 and 1988.

The Feldstein-Marris contention that the fall of the dollar signifies a growing risk attached to U.S.-dollar-denominated securities can be readily incorporated in the model just described. Instead of assuming perfect asset substitutability, assume that a risk premium is necessary

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[23] This coefficient is based upon the following regression, for monthly data 1978:1 to 1988:6:

$$\log(P/EP^*) = \underset{(22.55)}{-0.1688} + \underset{(19.83)}{0.066^*}\,(r - r^*)$$

$$R^2 = 0.76;\ \text{Durbin-Watson} = 0.24.$$

to induce foreigners to hold U.S.-dollar-denominated assets. Denote the risk premium per period by d. The interest arbitrage equation, equation 2, becomes

$$(x_{t+1})^e = x_t + (r_t - r_t^* - d_t). \tag{2'}$$

Summing over n years as before, and denoting the average of the risk premiums between year t and $t+n$ as d_{nt}, yields

$$x_t = x^e - n(r_n^e - r_n^{*e} - d_{nt}). \tag{4'}$$

Now, a rise in the risk premium requires either a depreciation of the dollar or a rise in the interest rate differential, or probably both.

The argument that the dollar is falling because of a rising d_{nt} can be checked by asking whether the dollar has fallen *more* than would be implied by a falling interest rate differential. Indeed, if the United States were in a true hard landing, the interest rate differential should actually be *rising* as the dollar is falling. We can see from figure 1 that this has not been the case. At least through June 1988, there is little evidence that a rising risk premium on the dollar was an important factor in the decline of the dollar.

Global Macroeconomic Repercussions of a Declining Dollar and Shrinking U.S. Trade Imbalance

A common refrain of U.S. policymakers and many economists is that the declining dollar and shrinking U.S. trade deficit impose contractionary forces on the rest of the world economy. If the declining dollar reduces U.S. demand for imports and raises U.S. exports, the argument goes, domestic demand abroad will tend to decline, since foreigners will lose part of the U.S. market and at the same time will devote more of their demand to less expensive U.S. products. Therefore, policy abroad, and particularly fiscal policy abroad, should turn more expansionary to counteract the deflationary impulses coming from the United States.

This argument is certainly not correct as a general proposition, and even the *sign* of the effect of U.S. policies on output abroad is difficult to predict, for the reasons outlined below. J.-P. Fitoussi and E. S. Phelps, for example, argued in 1986 that the U.S. fiscal expansion was a major contractionary force in Europe and that a U.S. fiscal contraction would be an expansionary policy for Europe.[24] The arguments that follow suggest that as the United States reduces its budget deficit, a sufficient action abroad to maintain demand would be mildly expansionary monetary policy. Indeed, it may actually turn out that the U.S. fiscal contraction is expansionary in its effect on foreign economies even with an unchanged path of the foreign money supply.

The effects of a falling dollar on growth in the rest of the world depend on the source of the dollar decline. If the dollar moved randomly without any link to economic fundamentals, then perhaps it would be possible to speak about the effects of an "exogenous" change in the exchange rate. As it is, we know that movements of the dollar are generally linked to movements in the interest rate differential, which are in turn linked to shifts in macroeconomic policy. Most of the rise in the dollar, at least until early 1984, followed the jump in U.S. real interest rates, which in turn resulted from the policy mix of loose fiscal and tight monetary policy. The decline in the dollar since 1985 is in turn tied to the partial reversal of that policy mix and the expectation of a further reduction of the deficit as a proportion of GNP, which has in turn lowered U.S. real interest rates relative to interest rates abroad.

The shifts in fiscal policy expectations, and in actual fiscal policy after 1985, are well known. The federal government budget deficit fell from a peak of 4.9 percent of GNP in 1985 to 4.8 percent in 1986, 3.4 percent in 1987, and a projected 3.1 percent in 1988.[25] The decline to date, which is projected to continue under current legislation to a level of about 2 percent of GNP in 1992, should by itself account for an improvement in the current account balance of about $0.4 \times (4.9 - 3.1) = 0.72$ percent of GNP, or roughly $34.9 billion in 1988.[26]

It is less appreciated that at the same time that the fiscal shift began, the Federal Reserve Board began a sustained monetary expansion, in support of the policy of driving down the dollar. Table 7 shows the year-over-year rates of growth of reserve money and M1 on a quarterly basis between 1984 and 1987, the period of dollar depreciation. There is a clear shift toward easier monetary policy at the beginning of 1985, at the same time that the interest rate differential started to narrow. The high money

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[24] J.-P. Fitoussi and E. S. Phelps, "Causes of the 1980s Slump in Europe," *BPEA, 2:1986*, pp. 487–513.

[25] See *OECD Economic Outlook*, no. 43 (June 1988), table 10, p.23.

[26] See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1989–1993*, table I-1, for forecasts of future budget deficits under current legislation.

Table 7. Money Growth Rates, United States, 1984:1–1987:2

Year and quarter	*Reserve money*	*M1*
1984:1	4.0	8.4
1984:2	6.7	7.5
1984:3	6.0	6.2
1984:4	6.3	5.9
1985:1	8.5	6.7
1985:2	8.4	8.3
1985:3	8.9	11.3
1985:4	9.9	12.4
1986:1	9.6	11.8
1986:2	9.5	13.1
1986:3	10.5	13.4
1986:4	14.9	16.5
1987:1	11.6	15.5
1987:2	8.7	11.8

Source: Author's calculations using IMF, *International Financial Statistics*, and updates from *OECD Economic Outlook*. Growth rates are quarter over same quarter of the previous year. Reserve money is defined by the IMF as the sum of currency in circulation, bank reserves, and demand deposits of the private sector with the monetary authorities.

growth continued until early 1987, when it began to slow. In response to this money growth, the economy expanded faster than the underlying steady-state growth rate, resulting in a fall in the unemployment rate between 1985 and 1988 of about 1.5 percentage points.

The McKibbin-Sachs simulation model can suggest the dollar exchange rate effects of the shift in the policy mix after 1985.[27] Table 8 shows the effects of an announced stepwise reduction in government spending, to result in a stepwise reduction in the budget deficit along the lines of (but smaller than) the Balanced Budget and Emergency Deficit Control Act of 1985, better known as the Gramm-Rudman-Hollings act. As shown in the table, the budget deficit is credibly expected to improve by 3.8 percent of GNP in nearly equal steps over a five-year period.[28]

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[27] Warwick McKibbin and I are now preparing a more precise assessment of the effects of the policy mix, where we examine closely the change in budgetary expectations on a year-to-year basis during 1979–87.

[28] In the simulation exercise, government spending on goods and services is cut each year by 0.8 percentage point of GNP. The change in the budget deficit is slightly less than the cut in spending because of an endogenous effect on interest rates and taxes. The overall size of the policy change is somewhat arbitrary (Gramm-Rudman-Hollings itself aimed for a larger correction of the deficit), but since the model is linear, the effects of a larger budget correction can be found simply by multiplying the numbers in table 8 by the proportionate increase in the experiment.

Table 8. Cumulative Effects on United States, Japan, and Germany of a 3.8 Percent Reduction in the U.S. Fiscal Deficit over Five Years[a]

Percent of GNP except where noted

	Cumulative effect				
Country	*Year 1*	*Year 2*	*Year 3*	*Year 4*	*Year 5*
United States					
Output	−0.4	−0.5	−0.5	−0.5	−0.2
Real trade balance	0.7	1.0	1.2	1.3	1.3
Inflation	0.6	1.1	1.4	1.8	1.9
Budget deficit	−0.6	−1.4	−2.2	−3.0	−3.8
Long-term real interest rate	−3.3	−3.7	−4.2	−4.5	−4.8
Japan					
Output	0.5	0.1	0.2	0.2	0.2
Real trade balance	−0.6	−0.9	−1.1	−1.3	−1.4
Inflation	0.0	−0.1	−0.6	−0.9	−1.2
Real exchange rate	10.0	15.0	18.1	20.2	20.5
Long-term real interest rate	−3.1	−3.3	−3.6	−3.8	−4.0
Germany					
Output	1.0	0.7	0.6	0.6	0.3
Real trade balance	−1.1	−1.5	−1.7	−1.7	−1.6
Inflation	0.5	−0.1	−0.5	−0.8	−1.3
Real exchange rate	10.9	14.8	17.3	18.4	17.6
Long-term real interest rate	−2.9	−3.1	−3.4	−3.7	−3.9

Source: Simulation of the McKibbin-Sachs Global Model (2), version October 1988.

a. The policy is an *anticipated* stepwise cut in government spending of 0.8 percent of GNP per year over a period of five years (thus, an overall cut of 4.0 percent of GNP in government spending). Note that the effect on the budget deficit is slightly less than the size of the spending cut, because of induced effects on government tax collections that are built into the model. The money supply is adjusted each year to maintain full employment. Output and the real exchange rate are measured as a percentage change of their baseline values. The trade balance is measured as a change in percent of baseline GNP. The inflation rate and long-term real interest rate are the changes from baseline in percentage points per year. A positive value of the real exchange rate signifies a depreciation of the dollar relative to the yen or the Deutschemark.

The simulation exercise assumes that monetary policy accommodates the fiscal policy shift, with the money supply changing enough to keep the U.S. unemployment rate constant as the fiscal policy is tightened. The policy shift leads on impact to a real dollar depreciation against the yen of 10.0 percent, and real depreciation of about 18.1 percent by the third year. This depreciation results from the fall in U.S. interest rates relative to foreign interest rates on impact of the policy change.

The simulation also shows the likely trade balance effects of a sustained application of budget cuts, both on the United States and on the rest of the world. According to the simulation results, the five-year program of budget cutting reduces the U.S. trade deficit relative to baseline by about 1.2 percent of GNP by the third year, and by 1.3

percent of GNP by the fifth year.[29] The 3.8 percentage point phased reduction in fiscal deficits (from a level of some 4.8 percent of GNP in calendar year 1986) does not come close to eliminating the trade deficit, which starts at 3.4 percent of GNP in 1986.

The 1.3 percent of GNP reduction in the U.S. trade deficit by the fifth year is accommodated by a shrinkage in the Japanese surplus equal to 1.4 percent of Japanese GNP, and by a shrinkage in the German surplus on the order of 1.6 percent of German GNP.

The demand effects of such a policy mix on the rest of the world can also be examined. The surprising feature of these simulations, one that is contrary to much conventional wisdom, is that the shift in the U.S. policy mix toward fiscal contraction and monetary expansion imparts an expansionary impulse to the rest of the world, even though it causes the dollar to depreciate and causes U.S. net exports to rise. This result stands in contrast to Marris's warning, for example, that "Europe and Japan have not yet taken expansionary fiscal policy action on the scale necessary to offset the inevitable negative drag on their growth as the U.S. trade deficit is eliminated."[30]

To understand the reason for the positive transmission effects, it is helpful to turn to the standard Mundell-Fleming model.[31] The direction of international transmission of monetary and fiscal policy in the basic theoretical model is ambiguous. In a U.S. fiscal contraction, for example, the cut in the U.S. budget deficit leads to a dollar depreciation, a fall in U.S. output, and a reduction in world interest rates. The first two effects have a contractionary effect on economies other than the United States, as U.S. demand for exports from these economies falls, while the third effect (the decline in world interest rates) should have an expansionary effect by raising their consumption and investment. The net effect is therefore ambiguous, even though many commentators presume that a U.S. fiscal contraction must slow growth abroad.

[29] In the October 1988 version of the McKibbin-Sachs model (2) reported in table 8, the effect of a deficit reduction on the trade balance is somewhat less than in the reported version of the model used in Roubini and Sachs, "Sources of Macroeconomic Imbalances in the World Economy," as reported in table 2.

[30] See Stephen Marris, "Deficits and the Dollar Revisited" (Washington, D.C.: Institute for International Economics, August 1987), p. 39.

[31] The model is described in Gillis Oudiz and Jeffrey Sachs, "Macroeconomic Policy Coordination among the Industrial Economies," *BPEA, 1:1984*, pp. 1–64; and in Michael Bruno and Jeffrey D. Sachs, *Economics of Worldwide Stagflation* (Harvard University Press, 1985).

The overall sign of transmission depends on the reaction of foreign wages to the appreciation of the foreign currency vis-à-vis the dollar following the U.S. fiscal contraction.[32] If foreign nominal wage growth slows down as the foreign currency appreciates, then it is more likely that the foreign economy will expand in reaction to the U.S. fiscal contraction. If the foreign nominal wage is perfectly rigid, on the other hand, then simple theory demonstrates that the foreign economy must contract in response to contractionary U.S. fiscal policy. The conventional wisdom is based on the simple model of fixed nominal wages. The McKibbin-Sachs simulation model, on the other hand, assumes a fairly high response in Europe and Japan of the nominal wage changes to consumer price changes, and therefore indirectly to exchange rate changes.

The theoretical ambiguity of the sign of international transmission is also true for monetary policy. A U.S. monetary expansion put in place alongside a contractionary fiscal policy has three effects: a dollar depreciation, a rise in U.S. output, and a fall in world interest rates.[33] The first effect tends to reduce foreign aggregate demand by shifting overall demand from foreign goods to U.S. goods. The second and third effects tend to raise foreign demand. Once again, the overall effect depends on the foreign nominal wage response to the exchange rate appreciation of the foreign currency that is caused by the U.S. monetary expansion. With nominal wage rigidity abroad, the U.S. monetary expansion must cause a decline in foreign output. With high nominal wage flexibility, the U.S. monetary expansion will cause a rise in foreign output.

These simulation results undermine the presumption that a shift in the U.S. policy mix toward fiscal contraction and easier money will reduce foreign aggregate demand. The presumption is especially weakened in view of the substantial evidence of a rather close relationship between nominal wage change and consumer price changes in Europe and Japan. The simulation results cannot, of course, prove the case one way or another. Since it is naive to believe that one could actually get sound econometric estimates of the transmission effect, the sign and size of the transmission effects from the United States to the rest of the world must remain uncertain.[34]

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[32] Oudiz and Sachs, "Macroeconomic Policy Coordination."

[33] In the simulation results, the fiscal policy contraction leads immediately to a reduction of long-term U.S. real interest rates by more than 3 percentage points. In Germany and Japan, the effect is 3.1 and 2.9 percentage point reductions, respectively.

The skepticism that the simulations generate about the conventional view, however, seems more realistic than the continuing "surprise" expressed in the past year about the vigorous growth in the European and Japanese economies despite the depreciating dollar. As predicted by the simulation model, Japan has experienced a domestic demand boom during 1987 and 1988 that has more than compensated for the negative growth effects of the declining real trade surplus. Similarly, in 1988, Germany is now experiencing 3.5 percent to 4 percent annual growth for the first time in many years, based on domestic-led investment demand. Many forecasters had predicted German growth this year of 2 percent or under.[35] It is notable that German unemployment continued to rise throughout 1982–84, when the Deutschemark was weak and exports to the United States were booming, and began to fall only after 1985, with the advent of dollar depreciation and Deutschemark appreciation.[36]

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[34] If, in the end, expansionary measures are needed abroad to compensate for the shrinking U.S. fiscal deficit (that is, if the export effects abroad turn out to dominate the interest rate effects), there are good reasons to look for policies that can raise demand while preserving the tight fiscal policies in the European and Japanese economies. In a world of insufficient overall saving, and with a particular scarcity of capital for the developing world, growth measures that maintain saving are of particular value.

Three kinds of stimulative policies could be pursued that would also not restrict global saving. Most obviously, any slowdown in foreign demand could be counteracted by expansionary monetary policies abroad. Second, in view of the acute unemployment rates in the EC economies, combined with German hesitancy to expand money growth, there would seem to be a case for a significant depreciation of the non-Deutschemark currencies within the European Monetary System, combined with a monetary expansion in those countries. Third, rather than undertake direct fiscal expansion, Europe and Japan could increase the recycling of money to the cash-constrained debtor countries. The global expansionary effects of an increased dollar of loans to the problem debtor countries is roughly equivalent to a direct increase of a dollar of deficit financing.

[35] In September 1987, the IMF predicted West German growth of 2.1 percent for 1988. In April 1988, the forecast was revised downward to 1.7 percent per year. In September 1988, the IMF projected 2.9 percent growth for the year. The main economic institutes of West Germany, as of October 1988, were forecasting around 3.5 percent per year. See "Budgets Built to Last," *Economist* (October 29, 1988), p. 76.

[36] The German unemployment rates for the years 1982 to 1987 were: 6.7, 8.2, 8.2, 8.3, 8.0, 7.9. See *OECD Economic Outlook*, no. 43 (June 1988), p. 187, table R18.

The Present Risk to the U.S. Economy: Overheating, Not Hard Landing

In my view, concerns about a hard landing for the U.S. economy are overstated. Over the next few years, risks probably fall more on the side of excessive inflation than on the side of a slump. In this final section, I outline two reasons for concern over inflationary prospects in the economy, both related to the depreciation of the dollar.

A significant part of the dollar depreciation since 1985 has been based on the expectation of a continuation of fiscal restraint along Gramm-Rudman-Hollings lines. Since the dollar has returned in real terms to the values of the late 1970s, when both the current account and the federal budget were in virtual balance, the level of the real exchange rate is likely, in the intermediate run, to lead to *excess* demand in the U.S. economy if the current levels of budget deficits persist. The combination of rising net exports, induced by the weak dollar, and the strong internal demand, induced by the continuing budget deficit, will spill over into excess demand and rising inflation. If the budget deficit remains stuck in place, then the dollar would have to appreciate once again in real terms. That could happen through a reversal of the nominal depreciation of recent years, or through a rise in the domestic price level, holding fixed the nominal exchange rate.

The second inflationary risk could arise if the monetary authorities were to attempt to push the dollar still lower through expansionary monetary policy, in the vain attempt to reduce the external deficit through money-induced dollar depreciation. As already noted, monetary ease can raise exports and overall income if there is less than full employment, but it is not particularly effective in reducing a trade imbalance. Any attempt to target monetary policy on the external balance is bound to lead to frustration and inflationary pressures.

So far, the inflationary effects of the weaker dollar have been modest, for two unexpected reasons. First, the pass-through of the dollar depreciation into higher import prices of finished goods has been lower than usual, as foreign producers have "priced to market" more than usual. Second, the dollar price of oil has continued to plummet even as the dollar exchange rate has weakened significantly. (Most other primary commodities prices have risen along with the decline of the dollar, in line with historical experience.) These factors have so far restrained the inflationary effects of the dollar's decline, and it is only a gamble that they can be relied upon in the next few years to help maintain price stability.

Comments and Discussion

Robert Z. Lawrence: As in a song currently near the top of the charts, the refrain in Jeffrey Sachs's paper is "Don't worry." In particular, don't worry about the rest of the world. Those of you who believe the United States should do nothing about the fiscal and trade deficits, don't worry—the world will finance it. Those of you who believe the United States should and perhaps—the optimists among you—will do something about the fiscal deficit, don't worry—U.S. budget cuts will not trigger world recession. Indeed, a fiscal contraction in the United States may actually be expansionary for the rest of the world. I should add that no one need worry about foreign willingness to finance the current account deficit.

I am sympathetic to the central message of the paper. Many who have been disappointed in the lack of U.S. fiscal discipline have forecast a crisis to spur greater action. In this vein the latest is the view that unless the next administration quickly takes a significant step toward reducing the deficit, we will see a crisis in the foreign exchange market, followed perhaps by a global recession. But the crash-landing forecasts have been notably inaccurate. The prediction was that a falling dollar would be associated with much higher U.S. inflation and interest rates, slow U.S. growth, and a slump abroad. In fact, since 1985 the dollar has indeed fallen—the decline has been of the order of magnitude predicted by Stephen Marris[1]—but it has been accompanied by lower U.S. interest rates, sustained U.S. growth, relatively low U.S. inflation, and a pickup in growth in Europe and (with a lag) in Japan. Now the critical reason for the differences between the crash-landing scenario and what has happened lies in the distinction between market-initiated and policy-initiated adjustment. The dollar's decline, as Sachs points out, has occurred not because of a stampede out of dollars but because of fundamental changes in policies. We have seen a shift toward easier monetary and tighter fiscal policy in the United States, and, I would add, a shift toward easier policies abroad. Indeed, OECD data show that Germany, the country we generally pick on as a growth laggard, increased its cyclically adjusted budget deficit by 0.3 percent of GDP in 1986 and 1987, and is expected to add an additional 1.0 percent of stimulus in 1988.

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[1] Stephen Marris, *Deficits and the Dollar: The World Economy at Risk*, Policy Analyses in International Economics 14 (Washington, D.C.: Institute for International Economics, 1985).

I also agree with Sachs that the current path of fiscal and current account deficits appears to be sustainable for several years. As I see it, the U.S. current account deficit will be on the order of 2 percent of GDP—or around $110 billion in 1989. Borrowing this amount for five years might add around three-quarters of a percent of GNP in permanently higher net foreign interest servicing but will not entail a solvency problem for the United States.

The current U.S. situation is in fact pernicious precisely because of the weakness of the constraints—both political and external. Simply because the situation is sustainable does not imply that it is desirable. The primary cause for concern is not the rest of the world pulling the plug but the slump in our national saving rate. While we may question the accuracy of our measures of the levels of national saving, the size of the real budget deficit, and the absolute magnitude of U.S. net indebtedness, no one disputes that there have been major declines in these variables in the 1980s. And yet, given the need to raise productivity growth and provide for the baby-boom generation's retirement, the United States should be saving more, not less, than its historic average.

The bottom line is that the United States looks creditworthy. A second consideration is foreign willingness to accumulate U.S. debt. In a world of imperfect substitutes, even creditworthy borrowers will have to pay higher rates to increase their borrowing. But Sachs points out that U.S. borrowing is a relatively small share of developed-country saving. He uses gross saving; I would use net. In that case the U.S. share is around 16 percent rather than 9.5 percent, but the borrowing still looks sustainable to me.

It is, however, important to remember that even net creditor countries can have sizable foreign exchange rate crises. Let me note some disquieting evidence that suggests such a crisis cannot be dismissed. First, Sachs argues that exchange rates can be readily explained by real interest rate differentials. But the fit is by no means perfect. There is a conspicuous divergence between actual and predicted exchange rates shown in his figure around the begining of 1985—a period many would argue was a bubble. And if we have had bubbles and irrational overshooting on the upside, we cannot rule it out on the downside.

Second, and in a similar vein, the market has been a biased and remarkably poor forecaster of exchange rates. Even those who think its judgment is the best we have must concede that it is not very good. I find it hard to find solace in the absence of a risk premium on U.S. debt. In 1981, commenting on a paper in this journal on LDC debt, Sachs himself dismissed the possibility of a crisis, based on evidence that the market placed low risk premiums on LDC debt.[2]

Third, recall that in 1987 official financing played a major role in supporting the U.S. current account deficit—suggesting that without this assistance, market forces might have driven the dollar much lower because of impatience about the lack of improvement in the current account. Once the improvement became clear to the market this year, private confidence was restored. The argument made by those of the crash-landing school is that once the current U.S. improvement comes to an end, private market jitters will return. Indeed, implicitly, the absorption approach Sachs uses to forecast the current account implies even less improvement than do most conventional partial-equilibrium models.

Finally, the crash-landing school would say that the United States has been incredibly lucky, both in having excess capacity in the global economy and in having falling oil prices. Such good fortune cannot be counted on in the future.

A foreign exchange rate crisis cannot be ruled out. It is of course important to remember that a sharp decline in the dollar need not mean a crash landing for the real economy. While a further decline in the dollar may present problems for macroeconomic policy, it does not necessarily lead to a U.S. or global recession.

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[2] Discussion of Robert Solomon, "The Debt of Developing Countries: Another Look," *BPEA, 2:1981*, pp. 593–607.

Ultimately the crash landing could come from two developments: first, a widespread perception the United States had entered a serious inflationary period (and was trying to renege on its debt), and, second, a sense that leadership in the United States was weak. Responsibility for avoiding the first possibility rests primarily with the Federal Reserve. A speedy response in U.S. interest rates that addresses the concern about inflation will, as we have seen over the past few months, induce foreigners to continue to lend. It will also, in the medium term, improve the current account by slowing U.S. growth. Responsibility for avoiding the second possibility rests with the president and Congress. They need to do more than communicate through lip-reading. The perception of a strong U.S. leadership would allow the United States to muddle through for a while, but divided leadership could make foreign investors very nervous.

Even if an exchange rate crisis were to erupt, the United States still has a major mechanism for procrastination—borrowing in foreign currencies. Foreigners sell dollar assets because of exchange rate and interest fears, not fears of U.S. insolvency. Foreign central banks, in particular, would probably accumulate Bush bonds for quite a while.

What about the danger of a foreign contraction if the United States actually does something about the deficit? I think Sachs has an important point about mechanisms that operate to stimulate foreign demand when the dollar falls. I would strengthen his point first by referring to the actual evidence on nominal wages over the past three years in the OECD. It looks as though nominal wages have fallen in every OECD country from 1985 to 1987. But I think Sachs fails to give sufficient credit to the most important mechanism—the endogenous policy responses. We live today in a mixed system of both fixed and floating rates. And we know unambiguously that monetary policy shifts lead to synchronized fluctuations under fixed rates. When the United States has eased monetary policy over the past few years, foreigners have tended to lean against the wind, resisting the appreciation of their currencies and increasing their monetary growth. This effect has also been clearly evident in the reverse direction this year as U.S. tightening has led to dollar appreciation and foreign resistance by tightening monetary policy. This mechanism suggests that a falling dollar induced by additional fiscal contraction in the United States is likely to raise foreign money supplies endogenously as it did in 1986. Indeed one would hope this would be the response. I give credit to expansionary foreign monetary and fiscal policies over the past three years for avoiding a global slump and would expect similar responses in the future.

Sachs makes an interesting case that, because it stimulates U.S. domestic investment, eliminating the federal budget deficit will by itself not suffice to bring the current account into balance. He also suggests monetary policy can have little or no impact on the current account. If he is correct, foreign investment must grow more rapidly than foreign saving to aid the U.S. current account adjustment. It will be important to stimulate European capacity expansion and allow developing countries debt relief, so they can shift toward investment-led growth.

Let me conclude by stressing that the U.S. problem is not solvency but an inadequate provision for the future. The main reason to reduce the federal budget deficit is to raise U.S. national saving over the long run, not to avoid a foreign exchange rate crisis in the short run. We and the world should be fine as long as the initiative for deficit reduction is held by the United States. Should the United States lose that initiative, however, a market-imposed adjustment cannot be ruled out.

General Discussion

Sachs's simulations showing that a reduction of the U.S. fiscal deficit has an expansionary effect abroad drew considerable comment. George Perry asked Sachs to elaborate on the mechanism that generates this negative transmission of fiscal policy. According to Sachs, the result relies on the responsiveness of foreign nominal wages to the depreciation of the dollar coming from the U.S. fiscal contraction. Foreign nominal wages must fall relative to foreign prices in response to cheaper U.S. imports that lower foreign consumers' cost of living. Sachs argued that this reduction in foreign wages will result in foreign output greater than that in the simple Mundell-Fleming model where nominal wages are fixed and the transmission of fiscal policy is positive.

Ralph Bryant observed that this negative transmission result distinguished the McKibbin-Sachs Global Model (MSG2) from other empirical models of the international economy, noting that it differed from all the simulations in a 1986 comparison of models in which Sachs and McKibbin both participated. Bryant acknowledged that foreign monetary authorities might well respond to a fiscal contraction in the United States with a monetary expansion of their own. Through that policy response, a

U.S. fiscal contraction could lead to an expansion of foreign output. However, he noted that the MSG2 simulations hold monetary policies fixed as the U.S. fiscal deficit is reduced. Peter Hooper noted that even in the 1986 simulations to which Bryant referred, several characteristics of the MSG2 model made it stand out from other models. By the very end of the simulation period the model predicted at worst a zero transmission of fiscal policy shocks. Furthermore, the model had an extreme, nearly one-for-one, response of foreign interest rates to U.S. rates. Other models displayed less than half as much decline in foreign interest rates in response to lower U.S. interest rates. Hooper noted that regardless of whether the MSG2 model is correct in its specification of foreign monetary reactions, Sachs's results suggest that the negative transmission effects of a U.S. fiscal contraction could be offset by a monetary expansion abroad.

Edmund Phelps believed Sachs's simulation results were plausible empirically as well as theoretically. He pointed to the pickup in the economies of Sweden, Britain, and Germany that had accompanied the reduction of the U.S. fiscal deficit without any major changes in these countries' own fiscal policies. Phelps went on to discuss simulations by John Taylor that showed the Fitoussi-Phelps expansionary effect of U.S. fiscal tightening on European output overtaking the Mundell-Fleming contractionary effect after about 10–12 quarters. Georges de Menil reported that, with a reasonable range of parameter values, simulations can yield ambiguous results on the transmission of fiscal policy, so there was no firm basis for predicting the effects on foreign output of U.S. fiscal contraction. But he added that the decline in world interest rates that would follow a reduction in the U.S. budget deficit is highly desirable.

Bradford De Long discussed the relation between the U.S. real exchange rate and the real interest rate differential. He observed that in Sachs's figure 1, the real exchange rate is now at about the 1979–80 level, but that the real interest rate differential is now about 3 percent higher than it was in 1979–80. De Long reasoned that either the equilibrium real exchange rate has fallen dramatically or, more plausibly, foreign investors now require a larger real interest rate differential in order to hold dollar assets. Peter Hooper agreed with the thrust of De Long's comment. He noted that, historically, a 1 percent change in the real interest rate differential has been associated with a 7 percent change in the real exchange rate. Since 1985, the real interest rate differential has fallen about 4 percentage points, thus accounting for a little more than half of the 55 percent fall in the real exchange rate. Hooper reasoned that the other half could be due to either of the two sources identified by De Long. However, Sachs noted that part of the fall in the real exchange rate should be seen as undoing the bubble that drove the value of the dollar about 20 percent too high in 1985.

James Duesenberry thought Sachs's focus on simplified models and simulations was too narrow. Clearly a hard landing will not be the most likely econometric forecast based on a reasonable range of policy choices. According to Duesenberry, the true risks come not from the steady-state accumulation of debt, but from exogenous events and contingencies that cannot be captured in a simple model. He advocated looking at the range of shocks, such as fears of inflation, fears of an adverse change in U.S. policy, or events elsewhere in the world, that might hit the economic system. For example, it is disturbing that substantial central bank intervention was required to support the dollar during 1987. He further advocated assessing the policy actions that governments will take in response to such shocks. The true risk lies in a situation where the authorities fail to pull themselves together to meet a crisis. Albert Wojnilower observed that a set of countries such as Japan, Korea, Mexico, and Thailand will, because of culture or outstanding debt, continue to produce more than they consume over the foreseeable future. Therefore, other industrialized countries should not engage in "beggar thy neighbor" policies in order to run current account surpluses. He saw the adoption of these negative sum policies by industrialized countries as an example of the type of risk emphasized by Duesenberry.

Benjamin Friedman discussed portfolio risks that might arise from the shrinking trade deficit. He observed that in certain markets for hard assets, such as real estate in major U.S. cities, foreigners have recently become essentially the only buyers. If the trade deficit is eliminated, this foreign demand for hard assets will dwindle, and prices for these hard assets might have to fall considerably before domestic investors are again attracted to buy. The fall in asset prices could have further repercussions if their domestic owners are highly leveraged. However, he added that it may be several years before this problem materializes because foreigner investors currently are holding a historically low proportion of their U.S. portfolios in the form of hard assets. Friedman predicted that foreign investors will continue to demand hard assets for a time as they attempt to balance their portfolios.

Mr. SACHS. If I tried to quantify how these factors have played out, I would put the measures as follows. Our trade deficit or current account deficit as a percent of GNP has worsened since 1980 by about 2.6 percent of GNP.

Let me parse out how those four factors have played a role. I would put our fiscal policy excesses as causing about 1.2 percent of that. This is based on various simulation studies. I would put the fiscal contractions in the rest of the world as explaining about 0.2 percent. So the divergence in fiscal policy is 1.4 percentage points of the 2.6.

The LDC debt crisis I would put as another 0.8 percentage points. In other words, in 1989, about $20 billion of our current account deficit can be attributed to the fact that the Latins can't borrow at the rate that they did before. And the decline of our private savings, which again is not a primary factor, but something going on the system, I would put as the residual, which is about eight-tenths of 1 percent of GNP.

And I think that is how the four factors more or less play out.

Now, in terms of getting the deficit under control, basically of course you need a rise of savings or decline of investment rates. We hope we don't have a decline of investment rates, so all our policies should be focused on a rise of savings.

A rise of savings rates can occur through a rise of public savings or a rise of private savings. We don't have a great handle on raising private savings rates, although I might be able to give in discussion some ideas about that. Our best handle is to raise public savings rates and that, of course, means less public dissaving or a smaller budget deficit.

Unfortunately, the bang for the buck in raising the public savings rate on the external balance is not everything that people think it is. People think that if you close the budget deficit 1 percent of GNP, then the external balance improves by 1 percent of GNP. All macroeconometric models and various kinds of other empirical evidence and theoretical evidence suggests that the tradeoff isn't one for one.

In my prepared statement, I summarize four models which suggest that for each 1 percentage point that we improve our budget balance, our trade balance or current account balance equivalently will improve by four-tenths of 1 percent.

This is a very important point. And the reason it's important, it means even if we get down to Gramm-Rudman targets by 1993, if we do that alone without any other major changes, we're still going to be running current account deficits in this economy.

We have about 3 percent of GNP left to go on the budget deficit. According to this coefficient of 0.4, that means there's 1.2 percentage points of improvement in the external balance that will come from meeting the Gramm-Rudman targets. That means that we will have 1.4 percentage points left to finish the job and that really requires a rise of private savings rates.

I don't think it's hopeless to get private savings rates up because they're at historical lows right now. They're at absolutely historical lows and we have to work on getting the private savings rate up as much as the public savings rate. In fact, when you reflect on the fact that our budget deficit is only 3 percent of GNP right now, which is more or less the median of the OECD countries, it's clear that we have a crisis only because our private savings are so low and therefore can't finance our public deficits.

Fiscal policy or improved private savings are the only ways to get the external balance improved. A weaker dollar right now through easy monetary policy will not do the job; it will just create inflation. That's partly because we're at full employment, partly because we have no spare capacity. If we weaken the dollar, we're just going to drive up prices in this economy. That's even true when we have excess capacity. Easy money as a route to a weaker dollar, as a route to improved exports, does not improve the trade balance because the easy money also causes import prices to go up. And that's the lesson of the last 3 years.

We have tried through easy money to drive down the dollar, improve the trade balance and so forth, and everyone has been disappointed with the results. The problem is it's illogical. You can't do it just through easy money and a weak currency. That just ends up with more exports and more imports if you have spare capacity, or purely more inflation if you don't.

Again, I have to come back to Latin America. Latin American governments love to try to improve their external balances purely through easy money and devaluations, and not tax increases and spending cuts. And we know the result now—this is what I have taught in my class for the last 10 years—and yet I think we have a temptation here to try let's just drive the dollar down and we'll get an improvement on the trade balance.

We can't do it unless we move on the budget much more significantly or get the private savings rates up.

The third point I want to mention is the question about a hard landing. If we continue as we're going and continue borrowing from abroad as heavily as we are as a percent of income, I would say in 5 to 10 years we're going to have very serious trouble. There's even the possibility of a panic before then.

The point of an article that I'll leave for the record is that that hard landing scenario is not likely in the short term. And this is perhaps a point that doesn't fit into the current rhetoric right now. It seems that either you have to be in favor of the budget deficits and say they don't have any problem, or to say that the world is about to fall in tomorrow.

What I try to do in this article is to say neither of those positions is right. We can probably go on like this for a while. I think it's really unfair to the future. I think it's an abnegation of national leadership. I think it would have costs 5 to 10 years down the road. I think we would end up like a Latin American country, eventually with a hard landing, but it is important to keep it seriously and honestly in perspective. We are not borrowing anywhere near as much as the Latin Americans did. Our public debt is nowhere near as extreme. In fact, our public sector debt as a percent of GNP has basically leveled off right now at about 43 percent of GNP, so we do not have a profound crisis in my view in the same way that a heavily indebted Latin American country would.

But please allow for a middle ground in the debate; that you can say that and at the same time not say that the deficits don't matter. We are not serving our future adequately even though there is not likely to be a collapse in the near term.

The fourth point I wanted to touch on was treating the symptoms. We're doing a lot of hammering on East Asia right now. The Secretary of the Treasury has declared that Taiwan and Korea are manipulating their exchange rates and so forth. What we're doing is willfully misreading the reasons for our problems. And while it may feel good to beat up on little countries that are selling us a lot of goods, this is highly irresponsible and it's going to come back to haunt us.

We are creating an anti-American reaction. I don't think it's wise. These are important strategic allies of the United States, at least Korea is an important strategic ally, and we ought to take our economics seriously and not go beating up on them for our problems.

I have recently done a study asking what would happen if they actually followed our advice and changed their exchange rates in the way we want them to.

And do you know what the answer is? It shows up in about the fourth decimal point of anything that counts for this country. Those countries cannot cure our problems, especially a country like Korea which still has a per capita income of $2,500. It just can't do anything.

So we ought to accept some responsibility, even though it feels very good to beat up on them to some people. This idea that they are somehow manipulating their currencies and doing damage to us just cannot sustain analytical support, and it's risky in my view to go down the road of this kind of rhetoric.

The fifth point I want to mention is the inflation risk. The dollar came down a lot. We brought it down a lot through easy money and through an anticipation of further improvements in Gramm-Rudman. If we continue on the Gramm-Rudman path seriously, I don't think we have to have an inflationary blowout in this economy.

If we stop and somehow get stuck in the budget deficit process, we are going to have, at current exchange rates, we're going to over full employment and we're going to have a rising inflation rate. We may already have that built in. That's what everybody watches, every tea leaf, every day now. Is inflation going to rise to 5 percent? Is it going to rise to 6 percent?

We're very close right now. We have to continue the Gramm-Rudman process or expect the dollar to appreciate sharply or expect a rise in inflation. And both of the last two alternatives are very poor for us.

Finally, I've abused my time limit, but if I could take 3 minutes on the debt crisis. I spend a great deal of my time in Latin America and have been doing so for the last 4 years. It was fairly plain to me 4 years ago that our management of the debt crisis was going to lead to a political and economic disaster in Latin America. That was not so clear to others at the time. Everyone said give the Baker plan time to work.

We've given it time to work. I think, when I look back on my congressional testimony over the years, I've hardly changed a line. I've just been saying it's going to be a disaster, it's going to be a disaster. We've arrived at the disaster now. Peru has a hyperinflation, Brazil has a hyperinflation, Argentina probably this month is going to start a hyperinflation. Mexico is at the point of class war if we're not extremely careful. There is disarray across Latin America, and yet the process of reducing this debt burden is absolutely stuck.

I was talking to my Bolivian friends whom I help advise through the United Nations yesterday. And they told me yesterday that in their meetings with the commercial banks, Citicorp made very plain, "We will do nothing for you, do you understand—nothing—because we will establish no precedence for a little country when other important countries are on the table."

This is not the case-by-case approach. This is absolute garbage from a point of view of American foreign policy. We cannot allow a few commercials banks to be doing such grave damage to our foreign policy interests in this region. They have tied up the process. Citicorp, as chairman of the steering committee of the major debtor countries, has absolutely locked up this process, has paralyzed it, and our government is not moving in to get these banks off of dead center and to get moving.

We cannot have a policy which allows the smaller counties to be thrown down the drain because the big banks want to wait to see what happens with Brazil and Mexico. Small countries have enormous repercussions for American foreign policy. Just look at Nicaragua to understand what a country of 3 million people can do to our foreign policy.

We have interests in Bolivia that are vital, interests in political stability, interests in democracy, interests in antinarcotics campaign. We have interests in Peru that are vital. We have interests in Costa Rica that are vital. We have interests in Ecuador that are vital. We cannot allow banks to so bald-facedly say we are not going to do anything for you when they then go out and testify to the committees here that they're in favor of a case-by-case approach. And even Citicorp had what I regarded as the absolute audacity a couple of weeks ago to praise a Bolivian buyback plan which they had, behind the scenes, tried to stop in the first round and are now stalling in the second round.

It is untenable to have privatization of American foreign policy in this region by a few of the largest banks. I would urge you, we are at a crucial moment right now. It is extraordinarily important that we renationalize American foreign policy and put it back in the State Department where it belongs and out of the bank steering committees. That is the only way we're going to be able to preserve the democracies in Latin America, and the time is really now for us to move.

Thank you very much.

[The prepared statement of Mr. Sachs follows:]

PREPARED STATEMENT OF JEFFREY SACHS

Mr. Chairman, and members of the Committee, thank you for the opportunity to appear today to discuss various aspects of U.S. international economic policy. Many of today's pressing issues fall under that rubric, and it is impossible to dwell on the full range of important topics. My brief remarks will focus on two important international policy matters: first, the trade deficit and exchange rate policy; and second, the management of the international debt crisis. I would be happy to discuss other issues related to trade policy, economic reform in the Socialist countries, burden sharing, and other international issues in the question-and-answer period.

I. The Trade Deficit and Macroeconomic Policy[1]

There are three aspects of the trade imbalance that I should like to discuss: the origins of the external imbalances; the role of macroeconomic policies in rectifying the imbalances; and the possibilities of a "hard landing" as a result of the trade imbalances.

Origins of the Trade Imbalance

On the origins of the imbalances, general public opinion makes the fundamental mistake of viewing the balance of payments (current account) imbalances as a reflection of trade policies and trade distortions. The large surpluses of Japan, Korea, and Taiwan, for example are almost universally attributed to protectionist policies in these countries. In fact, the sustained shifts in current account balances are almost always a reflection of savings and investment behavior unrelated to trade policies.[2] This is in fact true of the U.S. deficits as well as the large surpluses in Asia. While there may be cases in which a change in trade policies can affect the trade balance (through indirect effects on savings and investment behavior), there is little reason to believe that the emergence of large U.S. balance of payments deficits (on the current account) since the early 1980s has had anything whatsoever to do with changes in trade policies in this decade, either in the United States or abroad.

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[1] These remarks draw upon my recent study, "Global Adjustments to a Shrinking U.S. Trade Deficit", Brookings Papers on Economic Activity, 1988:2.

Ample research has stressed that four macroeconomic developments can account for the bulk of international trade imbalances that have emerged in the industrialized world in the 1980s. The first is the divergence in fiscal policies in the OECD economies, primarily the growth of U.S. fiscal deficits and the reduction of fiscal deficits in Germany and Japan. The second factor has been the liberalization of international capital flows in several countries, especially Japan, in the early 1980s. The third factor is the cutoff in lending to the debtor developing countries, which forced a reduction in their trade deficits, and thereby worsened the trade balances in the industrial world.[3] The fourth factor is a largely unexplained drop in the private savings rate, particularly since 1986. With these four factors, we do not need a bogeyman of "unfair trade" to explain the deterioration of the U.S. trade account.

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[2] Remember, of course, that the current account balance is equal not only to the excess of exports over imports, but also of savings over investment.

The major part of the damage has come from our own fiscal policy, which has reduced the national savings rate, and thereby worsened the external balance. If one considers the shift in the external balance as a percent of GNP, the deterioration of the current account since 1980 has been about 2.6 percent of GNP. As a rough estimate, based on previous simulation analyses, I would estimate that 1.2 percent of the deterioration has come from the shift towards budget deficit in the U.S., another 0.4 percent of GNP has come from the developing country debt crisis, another 0.2 percent of GNP has come from fiscal action abroad,[4] and approximately 0.8 percent of GNP has come from the decline of the U.S. private savings rate. These estimates are, of course, very approximate, but they should be useful as a guide to the relative importance of the various factors as work.

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[3] The sum of global trade balances must, in principle, equal zero. Thus, if the debtor countries must reduce their deficits (as their external financing dries up), then the rest of the world must reduce their aggregate surplus. This means, in effect, that the U.S., Europe, and Japan had to run lower trade surpluses (or larger deficits, in the case of the U.S.) as the debt crisis took hold. A reasonable estimate, based on a global simulation model that I have developed, attributes as of 1989 approximately $20 billion of the decline in the U.S. trade balance to the emergence of the debt crisis.

[4] Mainly the contraction of the Japanese deficit in the course of the 1980s.

Macroeconomic Policies to Rectify the Imbalance

The available macroeconomic evidence suggests that reducing the budget deficit is the surest route to reducing the trade deficit. Moreover, in the absence of budget deficit reduction, a further depreciation of the dollar is unlikely to improve the current account balance, and would instead contribute mainly to inflation. Based on a variety of macroeconomic models, it appears that the effect of the budget deficit on the external deficit is characterized by a coefficient of approximately 0.40: that is, each 1 percentage point of GNP reduction in budget deficit leads to an improvement in the external balance of approximately 0.40 of 1 percent of GNP.[5]

The fairly modest effect of fiscal policy on the current account deficit has an important implication for policy. Since the fiscal deficit was only one of the reasons for the emergence of large external deficits, even a complete elimination of the budget deficit (as called for by Gramm-Rudman, for example), other things equal, would remove only about half of the current external gap. That is, the external gap would fall to about 1.4 percent of GNP, from the current rate of about 2.6 percent of GNP. Balancing the U.S. current account will therefore require policy actions or other economic events (most prop~~r~~itious would be a strong recovery of household savings), beyond balancing the budget. Fiscal policies in other countries, moreover, are unlikely to make an important difference, according to all available macroeconometric modelling evidence.

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[5] This estimate is subject to a number of caveats described in Sachs, "Global Adjustments to a Shrinking U.S. Trade Deficit", op. cit., pp. 644-646.

Stressing the fundamental role of fiscal policy in restoring the external balance helps to avoid one fallacy common in policy discussions. It is sometimes suggested that the United States needs only a further fall of the dollar to balance its external accounts, without specifying how the depreciation is to be brought about. But the source of the dollar decline is crucial. To the extent that the dollar depreciates because of tight fiscal policy (which would lower U.S. interest rates and thereby weaken the dollar), the effect would be a further improvement of the external balance, as I have already noted. By contrast, to the extent that the dollar depreciation is induced by monetary expansion, the benefits for the external balance would likely be small, and the risks of higher internal inflation would likely be severe.[6]

Will there be a Hard Landing?

Virtually all economists bemoan the low savings rate of the U.S. economy, and the increasing national vulnerability from our national external indebtedness. I am certainly of such a view. But some economists go further, and suggest that not only is the low-savings policy short-sighted, but it is also likely to produce a calamity in the near future, through an international financial crisis. The basic idea is that foreigners will soon stop lending to the U.S., and by withdrawing the inflow of credits, will drive up U.S. interest rates, drive down the dollar, and push the U.S. economy into a stagflationary recession.

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[6] A monetary expansion tends to reduce interest rates and weaken the dollar. If there is excess capacity in the economy, the effect is to spur exports through a weaker currency, but also imports, through a more rapid growth of the domestic economy. If the economy is already at high capacity (as appears to be the case in the U.S. in February 1989), then the easy money simply causes a rise in inflation.

This scenario makes theoretical sense. Indeed, Mexico and Brazil have lived through such a crisis in recent years. After a careful analysis of the evidence, however, I would stress that such an outcome is only possible if the U.S. continues on its current path of foreign borrowing for several more years into the future, without restraint. As I have argued elsewhere,[7] the U.S. seems to be far from the kind of crisis that was experienced throughout Latin America in recent years. The U.S. net foreign debt is still relatively small as a proportion of GNP; and the fiscal deficits are not anywhere as large and out of control as were the deficits in the Latin American countries. Indeed, with respect to the fiscal problems of the U.S., it can be stressed that the burden of the public debt as a percent of GNP has more or less stabilized (with the debt equal to about 43 percent of GNP), so that we are not really approaching a case of explosive public sector indebtedness, of the kind that might trigger a foreign panic.

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[7] "Global Adjustments", op. cit., pp. 650-659.

The risks to the U.S. economy lie not primarily with a foreign-generated slump (as in the hard-landing scenario), but with a rise in domestic inflation that leads to a conventional recession based on tight domestic monetary policy. Given the continuing large budget deficits, and the weakness of the dollar in the past two years, there is risk of a rise in inflation to the range of 6 or 7 percent, high enough to trigger a Fed-induced recession. Thus, adverse price shocks (e.g. a sharp recovery of oil prices; a further decline of the dollar), are the sources of greatest vulnerability of the economy at the present time.

The Risk of Treating Symptoms Instead of Fundamentals

The U.S. external deficit has resulted from inadequate savings, but it is easy to blame on foreigners. Thus, in recent months, our rhetoric has heated up against Korea, Taiwan, Hong Kong, and other developing countries in Asia, that we have accused of manipulating exchange rates to our detriment. In a recent paper, I have analyzed whether exchange rate policy in these countries could help to explain the U.S. external deficits, and more importantly, whether changes in the exchange rates of Korea and Taiwan in particular, could make a material difference to the U.S. external balance. The answer is an emphatic no. By pressing these countries to change their exchange rates on our behalf, we risk doing significant damage to these economies (and to our longer-term relations with these economies), while doing almost nothing for the U.S. economy.

II. The Developing Country Debt Crisis[8]

The Bush Administration is now undertaking a review of policies with respect to the developing country debt crisis. This review is long overdue, as is painfully clear from the profound economic crisis and growing political instability that afflict almost all of the democracies in Latin America.

The depth of the crisis in Latin America is broadly known.[9] Peru has reached a point of social and economic collapse: annualized inflation rates of recent months are now no less than 30,000 percent; real GNP will likely fall by 15 to 25 percent in the 12 months from September 1988 to September 1989; and radical terrorism has come in full force to the urban centers of Peru. In Argentina, the infrastructure has deteriorated so completely that blackouts are the daily norm in Buenos Aires, and the telephone system in parts of that great city typically break down during rainstorms. Brazil too is headed towards a hyperinflation, with inflation exceeding 2,000 percent, and with a sharp political lurch towards to the left. And in Mexico, the vaunted political stability provided for decades by the PRI is now at a point of collapse. For anyone that cares to look, that country is at risk in the next few years of a drift into open class warfare.

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[8] These observations draw upon testimony that I gave yesterday to the Senate Banking Committee. In turn, that testimony drew heavily upon two recent studies of mine. The first is "New Approaches to the Latin American Debt Crisis", Harvard University, mimeo, September 1986; the second is "Efficient Debt Reduction", prepared for the World Bank Symposium on Dealing with the Debt Crisis, January 1989.

[9] I will focus my remarks on the situation in Latin America, which I know best and on a first-hand basis. The situation is Sub-Saharan Africa is perhaps even more dire, though it presents a different set of policy issues, mainly because the debt in Latin America involves the U.S. commercial banks, while the debt is Africa is mainly owed to official creditors.

Much of this was predictable on the basis of our policies towards the region, and indeed was predicted.[10] But our government's strategy was to ignore these trends, in order to give our commercial banks time to rebuild their capital bases. Unpleasant facts in Latin America were simply buried by an unrelenting publicity barrage from the banks that Latin American recovery was just around the corner, and by the message that Latin America's crisis was resulted only from policy mistakes within Latin America, and not from the incredible burden of debt combined with a collapse of primary commodities prices.

Mercifully, the process of rebuilding the banks' capital base relative to Latin American exposure is now complete. This point was driven home a few weeks ago by Mr. William Seidman, Chairman of the FDIC, in testimony to the House Banking Committee[11]:

> Moreover, even in what surely could be considered a worst-case scenario, each of the nine money-center banks could write-off 100 percent of their outstanding loans to these six [largest debtor] countries and, on an after-tax basis, each of these banks would remain solvent. (emphasis in original)

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[10] In May 1986, for example, I testified to the Senate Banking Committee on the urgent need for debt relief for many countries in Latin America. I singled out Peru, especially, as a country heading for profound turmoil if debt relief were not forthcoming.

[11] Testimony of Mr. L. William Seidman to the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, January 5, 1989.

This basic fact is underscored further by the all-time record profits of the U.S. money-center banks in the fourth quarter of 1988.

Debt reduction is now an economic imperative for Latin America, and a foreign policy imperative for the United States. In fact, significant debt reduction is now emphatically in the long-term interests of the banks themselves, since debt reduction will improve the economic performance of the debtor countries and thereby the ultimate value of repayments that the banks will receive. The problem is that even though extensive debt reduction is in the collective interests of the banks, it will not occur by itself, for the same reason that bankruptcy can't occur without bankruptcy law and bankruptcy courts. Debt reduction, like bankruptcy, needs an institutional setting to bring it about. Otherwise, the individual interests of particular banks come to dominate the collective interest of all of the parties in this crisis.

It is not hard to envision the proper institutional setting: an International Debt Facility (IDF), under the official supervision of the IMF and the World Bank, to intermediate the process of debt reduction. This policy proposal is now widely admired and supported, not only in the Omnibus Trade Act of 1988, but also in related variants by the Japanese and French Governments, leading commercial banks such as the American Express Bank, and the debtor countries themselves, in the recent declarations of the Group of Eight democracies in Latin America.

In my judgment, this policy initiative is now close to being implemented, as long as policymakers in the creditor and debtor countries keep their eyes on fundamental issues, and do not get distracted by the phony importunings of a few money-center banks. A few of the largest banks continue to pin their hopes on a mix of official bailouts (through increased IMF, World Bank, and Japanese lending), debt-equity swaps (despite their profound damage to the debtor countries), and debt relief granted by the smaller banks. This wish list of the largest banks is sometimes sold under the heading of "voluntary" debt reduction, which holds as much chance for long-term success as "voluntary" bankruptcy.

The debt facility proposal is typically attacked along several well-rehearsed lines, none of which withstands scrutiny. It is said that the facility would be: (1) a bailout of the banks; (2) too costly for the taxpayers; (3) an abandonment of the case-by-case approach; (4) inimical to policy reform in Latin America; (5) harmful to the restoration of new private lending to Latin America; and (6) administratively unfeasible.

These lines of criticism are unfounded, and are often based on a serious misreading of the debt facility proposal. I will conclude my testimony with an examination of the "myths" that surround the debt facility proposal.

Myth 1. A debt facility is a taxpayer-financed bank bailout

This is real whopper. A debt facility is the most effective and orderly way for insuring that the banks accept losses on their bad loans, rather than pawning them off onto the taxpayer via new lending from the IMF, World Bank, and creditor governments. A debt facility would require a concerted acceptance of bank losses for the first time in this crisis.

Myth 2. A debt facility is too costly for the taxpayer

This, no doubt, is the preeminent myth that has forestalled any action on the proposal. With the popular press fond of quoting a developing country indebtedness of more than $1 trillion, opponents of the debt facility are able to instill the notion that real relief would require hundreds of billions of dollars of taxpayer funds.

This is wrong on several points of view. The target of the facility is medium-and-long-term debt of the public sector of troubled debtor countries. This amounts to about $240 billion, with a secondary market value of the debt of about $90 billion. Other kinds of debt (e.g. debt owed to the IMF, World Bank; short-term debt; debt owed by the private sector; etc.) would not be part of the plan. Moreover, it is the banks, not the taxpayer that would assume the bulk of the losses under the debt facility. Roughly speaking, the debt would be cut from approximately $240 billion to $90 billion (in steps, and assuming that all countries eventually qualify for debt reduction, by undertaking adequate adjustment programs). The facility would guarantee the payments of part or all of the $90 billion due. The taxpayers would be liable only if the debtor countries could not manage to carry the burden of the $90 billion, and would be liable only for that part which remains unpaid by the debtor countries.

The U.S. share of the guarantees could be quite modest. In another detailed study, I have illustrated the very small amounts at stake by assuming that the Japanese would cover one-third of the guarantees, and the U.S. would cover one-fourth.[12] The result is that the U.S. ends up guaranteeing about $22.5 billion in liabilities of the facility. If paid-in capital is about 10 percent of the amount of the guarantees, the U.S. contribution would come to approximately $2.3 billion. This could be distributed over five years, with an annual budgetary burden of about $470 million.

Myth 3. A Debt Facility is contrary to the Case-by-Case Approach

This myth reflects a simple misunderstanding. Advocates of a debt facility do not advocate an across-the-board writedown of debt. Rather, comprehensive debt reduction would be available on a case-by-case basis, depending on the willingness of the country to undertake economic reforms. In each case, the extent of reform would be tailored to the economic needs of the country in question. Those needs could be ascertained based on a professional assessment of the weight of the debt burden, the solvency of the public sector, the extent of past losses in GNP as indicative of the growth potential of the economy, and so forth.

Myth 4. The Debt Facility is Inimical to Economic Reform

This notion is simply backward. The debt overhang itself is the greatest barrier to economic reform, because it destabilizes governments in Latin America, and thereby deprives governments of the political base to pursue sustained programs of reform. Moreover, it is virtually impossible to sell a program of economic reform in Latin America today, because the political opposition is only too quick to point out that under current arrangements, the benefits of reform accrue to the international banks, rather than to the domestic citizenry.

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[12] See "New Approaches to the Latin American Debt Crisis", Harvard University, mimeo, September 1988.

The real harm with the current policies is that politicians friendly to the United States in the region will find themselves increasingly undermined by opponents who attack the U.S. (and the rest of the creditor world) as the agents of oppressive debt collection.

Myth 5. Debt Reduction would be harmful to new lending

The banks have long argued that Latin America should be drained of approximately 5 percent of GNP per year in net interest payments, since to give relief would somehow restrict the access of the countries to "new lending". Since no real net lending is in fact available, the point has always seemed to me to be unreal in the extreme.

But more fundamentally, there is an enormous confusion about the linkage of debt reduction and new lending. In bankruptcy, for example the reduction of debt is seen as *vital* to *restoring* creditworthiness. It is common in a bankruptcy action that once the existing debts are reduced, the bankrupt firm may *immediately* return to the credit market for new financing based on a cleaned-up balance sheet. Similarly with sovereign debt, it is the debt overhang itself that prevents the return of the sovereign to the loan market, and the most effective way to *revive* lending for trade financing and fixed capital formation is to reduce the debt burden to a level that can be serviced by the debtor.

Myth 6. The Debt Facility is Administratively Unfeasible

A final myth is that the debt facility is unworkable because the banks might choose not to participate. And if the debt facility enters the secondary debt market to try to buy up the debt, the price will be driven too high to make a debt repurchase feasible. Once again, this myth reflects an enormous naivete over the actual workings of the loan market. The debt facility would not "go into the market" to buy debt. Instead, the banks as group (negotiating via the steering committee) would have to reach a comprehensive agreement with the country in order to qualify for assistance from the debt facility.

Since the major banks hold most of the debt, and since the vast majority of the banks would be only too happy to be relieved of their exposure in an organized manner, the debt facility can be made to work with the cooperation of a very small number of U.S. banks, including Citibank, Bank of America, Chase Manhatten, Chemical Bank, and Morgan. There are many carrots and sticks to induce participation, including regulatory changes, official guarantees, support from the IMF and the World Bank, etc. Moreover, it is highly unlikely that any of these banks would stand in the way of a reasonable settlement at risk of interfering with a matter of significant foreign policy concern of the United States.

Unanimity would not be required, moreover, since under the existing bank agreements, qualified majorities may change the terms of lending agreements for the entire group of creditors. David Finch, a long-time senior manager of the IMF, and one of the wisest observers of the debt issue in the world, has summarized the question of participation as follows: ". . . there is no question that the creditor governments have it in their power to give substantive legal protection to a majority settlement".[13]

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[13] See C. David Finch, "IMF -- The Record and the Prospect", Institute of International Economics, Washington D.C., mimeo, 12-30-88.

Representative OBEY. Thank you very much, Mr. Sachs. Mr. Williamson, please proceed.

STATEMENT OF JOHN WILLIAMSON, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. WILLIAMSON. Thank you very much, Mr. Chairman. I, too, am delighted to be here, to be able to participate in these discussions.

I agree with Professor Sachs about the nature of the two major financial dangers confronting the world economy at the present time: One, the risk that the opportunity of securing an orderly correction of the massive payments imbalances will be missed; and, second, the danger of the highly indebted countries, particularly in Latin America, failing to restore growth.

I also am going to talk about the first of those problems rather than the second, partly because both Professor Sachs and I testified elsewhere yesterday on the debt question. I am, however, appending to my prepared statement a speech that I gave in London in December which gave some idea of what I believe can and should be done about the debt crisis. But I want to emphasize the word "can" as well as "should," because I do have some doubts about the feasibility of some of the solutions, and that includes Professor Sachs' solution. The idea that one should renationalize American foreign policy in the way he describes might, I suspect, require nationalizing Citibank and a few other institutions and that might raise some other problems.

Let me start by talking about the danger of what could happen if the present payments imbalances are not corrected. That is the danger that's been referred to as a "hard landing," meaning a collapse of confidence in the dollar leading to the dollar falling too far, to a point where it exerts strong inflationary pressures, that combined with market pressures to push long-term interest rates up, pressures which I think the Fed would have to reinforce rather than attempt to counter because it also would want to stop the fall in the dollar because of the danger otherwise of inflation getting out of hand.

That, of course, is a recipe for returning to "stagflation," to a recession combined with inflation. And it seems to me that that is a very real danger even now.

It is perfectly true that some of us, in our Institute particularly, have been talking about this danger now for 3 or 4 years and it hasn't happened. And the question is sometimes raised: Does that mean that we were shouting wolf at the door when there was no wolf there, that there is in fact no danger?

I want to suggest that that is too complacent a conclusion. Back in 1984 rather similar things were said to those of us who said that the dollar was going to have to fall. We were told that we had been saying this for 3 years and we had been wrong, and so we must be wrong for the future. And it appears that many portfolio managers acted on the supposition that those of us who looked at the fundamentals were misleading, because they stopped looking at fundamentals. And that's why the dollar went even higher and helped wreak havoc with the American trade position, creating the deficit that we're still living with today.

I was a little surprised at what Professor Sachs said about there being no middle ground between not worrying about the deficit and thinking it's a great danger. Charles Schultz recently described it as a danger of termites in the woodwork as opposed to the wolf at the door. My own feeling is that one could probably live with the termites in the woodwork for a few years if one was sure that the wolf wouldn't be at the door when one got to the end of the process. That's not a defense of living with termites, even if one were sure that there were no wolves around!

In other words, the deficit does matter both in and of itself and because of the danger that as long as debt is increasing relative to all other magnitudes, that makes it much more likely that any shock to confidence will be translated into a major crisis.

Now, I conclude from that that the objective of policy should be not necessarily to eliminate totally the balance of payments deficit, but to stop debt increasing relative to GNP, relative to exports. And of those, the more restrictive condition is that it stop rising relative to GNP. So the intermediate objective that I set for the next 5 years or so is to try and stop the debt-GNP ratio rising.

Why do I think it wouldn't be sensible to aim for a balanced current account? For two reasons. One, because, as Jeffrey Sachs more or less implied, that would probably require a budget surplus of substantial size in the United States, and that looks as though it would raise some political difficulties, shall we say.

The other objection is really more fundamental. And that is that at the present time the United States, along with Canada, are the only two OECD countries expecting a rise in labor force in the next decade. These are the countries where the relatively high investment requirements will be.

They also have relatively low savings rates, and while it's right to deplore how low the savings rate is, there is a logical reason why it's relatively low, related to demography and the fact that a large part of the labor force is in the younger generation, under 45, and therefore relatively high spending as compared to those preretirement years where there's a larger part of the labor force in Europe and Japan.

So, in moderation, it seems to me that a continuing capital flow from Japan and Western Europe to the United States over the next decade or so is perfectly rational and ought to be acceptable; that what one ought to be doing is making sure that the deficit falls to the point where the debt is no longer rising relative to GNP. And a deficit of 1 percent of GNP is quite consistent with that. That would be a deficit of something like $60 billion a year by 1992. So the target that I set is an improvement of $70 billion a year rather than of $130 billion a year from where we are now.

I just want to make one passing remark about the counterpart to that in other countries. Korea and Taiwan are countries which have enormously large current account surpluses. It is necessary to have countries in the rest of the world ~~that are~~ willing to accept reductions in their surpluses as the counterpart to the U.S. reduction in its deficit if this process is to go through in a trouble-free manner.

While I sympathize with what Professor Sachs said about not beating up on Korea and Taiwan—and I get upset by some of the language that's used—it seems to me that the basic point that these countries are running surpluses that are quite irrationally large from their own point of view, and that also happen to be inconsistent with a smooth international adjustment process, is a perfectly legitimate point which American diplomacy is entitled to convey to those countries in appropriate terms.

Having set out what I see as the sensible objective, the next question is, of course, how to get there. And here I agree absolutely with what has been said by my predecessors about the key issue being that of reducing spending in the United States. Since the country is now at full employment, perhaps even slightly above so that inflation is tending to accelerate, the key here has to be reduced spending and it can't be additional output.

I think that it is the pressure of demand which has to be the primary explanation of the recent stall in the improvement in the trade deficit. Nine months ago, there was considerable optimism that the deficit was on a falling trend. Now there isn't. I don't think that's because there were no incentives to increase exports further. I think it's because the domestic economy is so strong that it's pulling in imports and thereby preventing any further improvement.

Now, I would like, if I might, to ask you to take a glance at an equation that I laid out in my prepared statement, which says in an equation exactly what Professor Sachs said orally. The current account deficit is the difference between domestic investment and domestic savings, and domestic savings, of course, is private sector savings minus the budget deficit. That tells one that to improve the current account deficit, one either has to decrease domestic investment, increase private sector savings, or decrease the budget deficit.

We surely don't want to decrease investment at this point. That would simply be undercutting the possibility of future growth, and indeed of future export increases.

It would be lovely to increase private sector savings, and it is absolutely true that that is the element which is out of line with the general international experience, rather than the budget deficit. But there's a great problem about increasing private sector savings, and that is that the Government has no lever it can pull which will increase private sector savings.

Higher interest rates have an ambiguous effect in theory and an effect that appears to be rather small empirically. Certainly the supply-side remedy of tax cuts didn't achieve that objective. So if one wants to do something about the current account deficit and one recognizes that that has to become by cutting spending, I see no alternative but to work on the budget deficit.

I go on to argue that in order to cut the trade deficit by the desirable $70 billion a year, it would be necessary to cut the budget deficit by more than that. In fact I came to a higher figure than that of Jeffrey Sachs. He said that 40 percent of every cut in the budget deficit could be expected to feed through to the foreign balance. I wondered whether one could expect much more than 50 percent of a cut in the budget deficit to feed through into a cut in spending—because of offsetting increases in investment as interest rates fall in response to the cut in the budget deficit, and perhaps even because of a response in the form of lower private savings. Insofar as you believe the argument that taxpayers get worried about seeing debt increasing in the future, and so they save to meet the tax payments they will have to make—if you put the process into reverse, you actually have to expect further cuts in private savings. So I wonder whether we could even expect spending to fall by as much as 50 percent. Then only some fraction of a fall in spending feeds through into an improvement in the trade balance at a constant exchange rate. I guessed that at 35 percent, which would mean that one was getting a bang for the buck, if you like, from a cut in the budget deficit to an improvement in the trade deficit of something under 20 cents on the dollar rather than Jeffrey Sachs; 40 cents on the dollar. So there is a major issue there.[1]

Hence my rough estimate is that a $140 billion cut in the budget deficit would produce something like a $70 billion cut in spending of which some 35 percent, something like $25 billion, would be an improvement in the trade balance, while $45 billion would be a slackening in the economy. And right now I think we could do with a little bit of slackening to ease off inflation.

But clearly one wouldn't want a large and continuing element of slack. If you want to improve the trade balance further, then one normally argues that one has to do something additional, and that something additional is to let the dollar fall. Let interest rates fall, carry the dollar down with them, and then that depreciation leads to an improvement in the current account.

So that leads me on to discuss where the dollar exchange rate needs to be in order to support the adjustment process to get the current account deficit down to $60 billion a year. On the conventional models, a further $45 billion improvement would need a depreciation of something like 5 to 10 percent in the level of the dollar as of the end of 1988. It has gone up about 3 percent since then.

However, there is some worry as to whether these models that we're using at the moment are sufficiently long term to take account of the supply-side impact of the adjustment. At the present time, the relative unit labor costs, the cost of employing a unit of labor in productivity-adjusted terms in the United States, is at a historical low relative to other industrial countries. It has been argued that this is the critical variable in driving the willingness to relocate investment around the world: that insofar as investment gets relocated in response to economic incentives, it is this which drives it. And this is currently at an extremely competitive level in the United States, and that does suggest that perhaps there are some longer term supply-side effects still in the pipeline from the dollar depreciation. Hence it may be that a depreciation of another 5 to 10 percent, as indicated by the models, is on the high side.

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[1] A clarification of John Williamson's oral presentation: In my oral presentation, I compared my estimates of the proportion of a cut in the budget deficit that would be passed through into a cut in the trade deficit with those offered previously by Professor Sachs. I stated that my estimate of just under 20 percent (35 percent of the cut in spending, which I put at 50 percent of the cut in the budget deficit) was substantially less than the 40-percent passthrough quoted by Professor Sachs as implied by his model.

It turns out that I was not comparing like with like. My estimate assumed a constant exchange rate, while his simulation allowed the exchange rate to depreciate to maintain full employment. If I perform a similar mental experiment, my figures would imply a passthrough of 50 percent or somewhat less. In fact, I would regard his 40-percent passthrough as a quite acceptable best estimate of what should be expected with a flexible exchange rate.

What I do believe is that it makes a great deal of sense to try and give some longer term guidance to the private sector as to where one expects to see exchange rates in the longer term so as to reinforce these positive incentives to invest in the United States at the present time. The problem is that every time there is any strength shown by the U.S. economy, the dollar tends to bounce back up again. And there are many businessmen who appear to worry that if they start investing now, they will get caught in a squeeze, as happened to them in the early 1980's. And so, because of that, they are reluctant to make the commitment to invest here. It seems to me the most useful thing that one could do to overcome that reluctance is not to try and push the dollar down yet further, but to give an assurance that it won't be allowed to bounce back up again.

That takes me back to the old proposal for target zones for exchange rates. Right now it seems to me that the sensible place to fix a target zone would be so that the current value of the dollar was quite close to the top of the zone. Probably it is going to be necessary to have some modest further depreciation, though it's not certain, at least from the level as of the end of last year. But in fixing a target zone, one might have the dollar now within 3 or 4 percent of the top of a zone 20 percent wide. That would be the sort of starting place that I would think of.

Finally, I want to say that this seems to me to be a uniquely opportune moment to get the adjustment in the U.S. balance of payments position and the other major payments imbalances in the world because of the fast growth elsewhere in the world, other than Latin America—and also one might mention the sub-Saharan in Africa. If you take the developing countries east of Iran, and that is still two-thirds of the developing world, they also are enjoying a major boom. It's not just the rest of the OECD which is now having the highest growth rate since the early 1970's, but also two-thirds of the developing world. The markets are there to absorb additional goods that could be exported from the United States. We could make the adjustment without a recession if it comes at the present time. And some restraint is needed in the United States as well for anti-inflation reasons.

So I know that the conclusion is very boring, that what one needs to do is to reduce the budget deficit, but it happens in my estimation to be true. The real tragedy is that it looks as though the opportunity is going to be missed because of what I at least regard as a misguided election pledge not to correct the deficit in the straightforward, honest, and efficient manner.

Thank you.

[The prepared statement of Mr. Williamson, together with an appended speech, follows:]

PREPARED STATEMENT OF JOHN WILLIAMSON

ACHIEVING A SUSTAINABLE PAYMENTS POSITION

The world economy is today confronting two major financial dangers. One is that the opportunity of securing an orderly correction of the current massive payments imbalances will be missed, resulting in a "hard landing". The other is that the highly indebted countries will fail to reestablish robust growth, with all the economic waste and political turmoil that such failure would nurture. I hope that these Hearings will help preempt those dangers, and I am honored to have been invited to testify.

My statement today will focus on the first of those two issues. I am appending the text of a speech that I gave in London in December which presented my views on what can and should be done about the debt crisis. (I would emphasize the word "can" as much as "should", because a number of proposed solutions seem to ignore the constraints imposed by the attachment of the courts to the common-law principle of sanctity of contract.)

The Hard Landing Scenario

The term "hard landing", invented by my colleague Stephen Marris, seems to mean somewhat different things to different people. I use it to refer to a situation in which a collapse of confidence in the dollar leads to substantial downward overshooting combined with market pressures for higher long-term interest rates--pressures that the Fed could be expected to reinforce in order to stop the fall of the dollar and thus limit the acceleration in inflation that would otherwise develop. The rise in interest rates could threaten a recession in parallel with the increase in inflation.

This "hard landing" scenario has been a threat for several years already. The fact that it has not yet materialized does not mean that the possibility of its future occurrence can be dismissed. On the contrary, the situation is perhaps reminiscent of that in 1984, when warnings that the dollar was bound to fall were widely dismissed on the ground that these warnings had by then been proved wrong for three years. The fact is that, the longer the payments imbalances persist at present levels, the greater are the cumulated stocks of debt and hence the more vulnerable the system is to shocks to confidence. Those of us who worry about the danger of a hard landing may be faulted for having exaggerated the certainty that a short-run crisis was inevitable, but that does not excuse a complacent assumption that the danger of crisis is nonexistent. It will remain a threat until the US external debt ceases to increase relative to the means of servicing the debt, namely US GNP. (To phrase the matter in terms of a much-quoted recent analogy: the United States could probably live with the termites in the woodwork if it could be sure that the wolf would not be at the door after the termites have been at work.)

A Sustainable Current Account

Important as it is to reduce the current account deficit to a sustainable level, it is unnecessary for the United States to aim at current account balance--let alone surplus--in the next few years. For the next decade or so the United States and Canada will be the only two industrial countries with expanding labor forces and hence relatively high investment needs. Meanwhile the baby-boom generation is in a relatively low-savings phase of the life-cycle here, while in other industrial countries an abnormally large proportion of the labor force is in the high-savings, pre-retirement years. In these circumstances (which will change about a decade from now) it is sensible for the United States to import capital.

The objective should therefore be to reduce the need to import capital to a level that is safely sustainable. A deficit of some 1 percent of GNP would imply stabilizing the debt/GNP ratio at some 14 percent, well within the range that other countries (and indeed the United States itself in the last century) have borne without running into crisis. This would involve a current account deficit of around $60 billion per year by 1991-92. I regard that as a sensible target.

Reducing Spending

Since the US economy is if anything now operating with a somewhat excessive pressure of demand, carrying the risk of a gradual acceleration of inflation, a reduction of the current account deficit will be possible only if domestic spending is reduced (or, strictly speaking, if domestic spending rises less rapidly than capacity is growing). An elementary accounting identity helps identify the alternative ways of curtailing spending that could be used to cut the current account deficit:

$$\begin{aligned}\text{Current account deficit} &= \text{Domestic investment} - \text{Domestic savings}\\ &= \text{Domestic investment} - \text{Private sector savings} + \text{Budget deficit}\end{aligned}$$

Thus one way of providing the room for the needed $70 billion reduction in the current account deficit would be to cut investment by $70 billion. Such a policy would, however, be shortsighted, since it would threaten future growth, and even the longer-term ability to increase exports to improve the current account. A second way would be to increase private sector saving. This would seem a rather attractive option, inasmuch as the private saving rate in the United States is exceptionally low by international standards (and also compared to past experience in the United States). The problem is that we do not know of any policy instruments that can be relied on to increase private savings (once the economy is operating at full capacity). The effect of higher interest rates is theoretically indeterminate and appears empirically to be modest. The effect of lower taxes promised by supply-siders was not evident. Hence the conclusion that, if domestic spending is to be reduced to make room for the needed reduction in the current account deficit, it will have to come from a cut in the budget deficit.

A reduction in the budget deficit will not be translated into an equal decline in expenditure, let alone in the trade deficit. First, the prospect of lower budget deficits will reduce interest rates and thereby increase domestic investment. Second, the prospect of lower budget deficits may lead taxpayers to anticipate lower future tax burdens and therefore induce them to save less. A reasonable guess is that with unchanged monetary aggregates these two effects might offset a half of the impact of fiscal contraction on domestic demand. Thus a desire to create room to improve the trade balance by some $70 billion per year requires elimination of the $140 billion budget deficit.

Since the Gramm-Rudman-Hollings Act mandates elimination of the budget deficit by 1993, it may be asked whether my analysis points to the need for any action additional to that of implementing existing legislation. It seems to me that the existing legislation is unsatisfactory in two major respects.

(1) It would be desirable to achieve a substantially larger fiscal correction in the immediate future than that mandated by Gramm-Rudman-Hollings, for two reasons. The first is that the US economy already suffers an undesirably high rate of inflation and

that the present pressure of demand is producing a (still mercifully modest) acceleration in inflation. In these circumstances it would be prudent to seek a rather modest growth rate, of no more than 2 percent, for the next year or two. To the extent that the Fed agrees with this appraisal, one can anticipate that a failure to secure a large, prompt cut in the budget deficit will result in higher interest rates rather than higher growth. The second reason is that growth in the rest of the industrial world--and also in that two-thirds of the developing world located east of Iran--is at last looking robust. This provides the conditions in which one could expect that a rather large proportion of any cutback in domestic demand would be translated into an improvement in the trade balance. Circumstances are rarely so propitious for a relatively painless adjustment.

(2) Doubts about political determination to persevere with the Gramm-Rudman timetable are liable to persist until the measures to implement the intended cuts have been agreed. One possible source of worry is that any suspension of the Gramm-Rudman targets triggered by a recession could become the occasion to revise the entire timetable. Another is that difficulty in agreeing on the distribution of cuts could again be met by modifying the timetable, as in 1987. The way to resolve these concerns is to redefine the objective in terms of the structural ("full employment") deficit and to agree now on the measures to secure fiscal consolidation in the years ahead.

The Dollar Exchange Rate

The net reduction in spending that resulted from a lower budget deficit would partly fall on imports. It would also reduce domestic absorption of goods that might then become available for export. These direct effects suffice to translate some proportion of the reduction in domestic demand into an increase in external demand. Estimates of this effect vary from a minimum of 11 percent (the proportion of US spending directed to imports) up to nearly 50 percent; my best guess would be in the region of 35 percent. That would mean that a $140 billion budget cut that reduced domestic spending by $70 billion net would improve the trade balance by $25 billion and curb output by $45 billion.

Indirect effects might be expected to reinforce those direct effects. Specifically, the lower US interest rates could be expected to reduce interest rates in other industrial countries, which would stimulate their domestic demand and thus their imports. Lower worldwide interest rates would also tend to stimulate demand from debtor developing countries whose interest bills would decline. It is difficult to know how much weight to place on these indirect effects, but I suspect that they could be quite important, possibly of a magnitude comparable to the direct effects.

Suppose for the sake of argument that the indirect effects crowd in external spending equal to an extra 15 percent of any cut in domestic spending. That would mean that with a constant exchange rate the $70 billion cut in net domestic spending would be divided into a $35 billion decrease in the trade deficit and a $35 billion fall in output. To increase external demand by a further $35 billion and thus prevent the fall in output would require a depreciation of the dollar. Conventional models estimate that the dollar would need to fall by between 5 and 10 percent to accomplish this.

It is not clear, however, that these models capture the long-run supply-side impact of exchange-rate changes. There is some evidence that the international location of manufacturing investment responds to relative unit labor costs. US unit labor costs have recently been more competitive relative to other industrial countries than at any time since records began. The most useful step that the United States could take to stimulate investment in export industries would be to reassure businessmen that the dollar will not again be absentmindedly allowed to appreciate to levels that would threaten the profitability of their investment. Such a commitment would be a more effective incentive than a further big fall of the dollar, which most prudent businessmen would expect to see reversed before long.

In my view such a target zone could be adopted now provided that it had wide bands (± 10 percent), since my best estimate of the rate compatible with current account equilibrium is less than 10 percent below the present market rate. The target zone would place the current rate near the top of the zone, which is consistent with the current cyclical strength of the economy. The zone itself should be expected to depreciate gradually over time, both to neutralize the excess of US over foreign inflation and to provide a modest continuing improvement in competitiveness so as to help reduce the trade deficit to finance the increasing burden of interest service.

Summary

A continuing US current account deficit of the present size is dangerous. The major policy change needed to achieve a sustainable payments position (a deficit of perhaps $60 billion per year) is a large, prompt cut in the budget deficit, plus early agreement on the actual measures that will complete elimination of the structural budget deficit by 1992. Such preemptive restraint could usefully be associated with a public commitment to wide target zones which would place the current exchange rate near the top of the zone. This commitment would encourage investment in export industries by providing reassurance against a renewed dollar appreciation not based on fundamentals, while leaving scope for a further modest above-trend dollar depreciation should that prove necessary to secure the switch into exports of all the resources released by budget restraint. This is a uniquely opportune moment to secure payments adjustment (and minimize the threat of renewed inflation) with minimal danger of recession. Unfortunately it looks as though the opportunity will be missed because of a misguided election pledge not to deal with the budget deficit in the most straightforward, honest, and efficient manner.

Debt Reduction: Half a Solution*

John Williamson
Senior Fellow
Institute for International Economics

The major development on the debt front over the past year has been intellectual acceptance and practical implementation of the concept of debt reduction. It is no longer true that the only way of helping a troubled debtor that is sanctioned by the official sector or accepted by the banks is additional lending. Many banks now participate in debt/equity swaps, some debtors have bought back a part of their debt on the secondary market for a fraction of its face value, and some debt has been swapped into alternative assets with a lower debt-servicing cost. These all provide methods by which the burden of the debt can be and is being reduced.

The advent of debt reduction is welcome, but it is unlikely by itself to suffice to resolve the debt problem, at least in the absence of a markedly more benign global environment. Let me spell out the limitations.

First, debt-equity swaps. This has so far been the principal mechinism employed, with $10 billion or more already swapped in 1988. A debt-equity swap typically involves a bank selling debt on the secondary market to a foreign company, which in turn sells the debt to the central bank of the debtor country in return for local currency with which it makes an equity investment in the local economy. This changes the form of the foreign claim on the debtor's economy from debt to equity, which may have some attractions in terms of improved efficiency consequential on foreign management and also generates a time-stream of debt-service obligations that is more responsive to the state of the domestic economy. But it has only a modest effect in reducing the debtor's net international liabilities--an effect that is dependent on the central bank paying less than 100 cents on the dollar for the debt that it buys back (i.e., splitting the secondary market discount with the foreign investor). Thus $10 billion of swaps may have made a dent of no more than $2 billion or $3 billion in foreign liabilities (some 1 percent of the debt to the banks).

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* Outline of remarks to be presented to the session on "Practicable Solutions" at the conference on "Growing Out of Debt" organized by the All Party Parliamentary Group on Overseas Development and the Federal Trust at the House of Commons on 6 December 1988.

Moreover, in some countries, notably Brazil, the pace of debt-equity swaps has been excessive this year. Unless the foreign investor buys a newly privatized asset (a phenomenon that was important in Chile), the central bank has to increase the monetary base in order to provide the local currency to the foreign investor. (In principle the government might issue local currency debt instead, but this is distinctly unattractive in countries where the real interest rate far exceeds the real interest cost of foreign debt.) Some observers believe that the magnitude of debt-equity swaps played a big role in driving Brazil to the verge of hyperinflation, which explains why the program has now been dramatically scaled back. In the future I would expect debtors (supported by the IMF) to be more cautious and seek to limit the volume of debt-equity swaps to a level that the economy can afford.

Second, buybacks. In March 1988 Bolivia bought back almost half its bank debt (using money specially donated by friendly governments) at a price of 11 cents on the dollar. In September Chile got permission from its bank creditors to use a part of its windfall gains from the high copper price to buy back debt on the secondary market. A part of the academic literature argues that buybacks are a mistake from the debtor country's standpoint because they involve the use of money that a country could spend on itself in order to eliminate debts that will not be paid in any event. I regard this analysis as nonsense: debts that are not being fully serviced are an obstacle to full participation in the world economy, a constant source of embarrassment, and a potential disincentive to adjustment. When they can be bought back cheaply because some banks are anxious to exit from the lending process at almost any cost, it is foolish not to exploit the opportunity.

The problem is that buybacks require cash, and--almost by definition--troubled debtors are short of cash. Hence any solution to the debt crisis that relies on buybacks to reduce outstanding debt is liable to take a very long time indeed. Buybacks are likely to increase in importance relative to debt-equity swaps, because it is more attractive to the debtor to allow inward foreign investment over the foreign exchanges and then, when it seems desirable, to use the proceeds to buy back a part of its debt on the secondary market. This has two attractions: it allows the debtor to capture 100% of the discount rather than share it with the foreign investor, and it gives the debtor a continuing choice as to whether to amortize debt or increase imports (or reserves). Hence, as banks become accustomed to granting waivers to facilitate buybacks and as the need to subsidise inward equity investment wanes, I expect to see debt-equity swaps largely replaced by buybacks. But that will not change the conclusion that both these techniques together could only reduce the debt very slowly.

More rapid progress will require the use of debt-debt swaps. This is why many observers have called for the creation of some international debt agency that could buy up the debt at a discount, issue its own obligations (carrying its guarantee) in return, and pass on the saving to the debtor countries. In my view this proposal does not qualify under the title of this session, namely "practicable solutions". I suspect this would be true even if the incoming US administration were not implacably opposed to all such proposals (which it is): the problems of persuading all the banks to participate, of deciding which countries should be allowed to sell their debt and at what price, and of garnering the public funds to finance such an agency, would be formidable.

What may be practicable are more modest proposals for debt-debt swaps that do not envisage compulsory participation by all banks or the need for an international agency to fix the price at which debt will be swapped. The precedents here are the Mexico/Morgan deal, and the exit bonds issued by Argentina in 1987 and Brazil in 1988. Unfortunately none of these precedents are particularly encouraging: banks proved unwilling to swap on terms and/or a scale that would have achieved substantial debt reduction. The reason is straightforward: the quid pro quo the banks seek for substantial debt reduction is more rapid and/or more secure exit from their sovereign risk, whereas what they were offered was largely continued country risk.

The security sought by the banks could be provided in three ways: by collateralization, by subordination, or by guarantees. The disadvantage of collateralization is that, like a buyback, it requires the debtor to use its reserves. Indeed, reserves cannot be expected to buy more debt relief per dollar if used in collateralization than in buybacks (which implies that the Miyazawa Plan is unlikely to get us far). Subordination of existing debt to exit bonds looks attractive until one learns that the required waiver would require unanimity on the part of the banks, which certainly places it outside the category of practicable proposals. Hence I conclude that a major role for debt-debt swaps would require the provision of guarantees for exit bonds by some public sector agency; the World Bank seems the natural choice for this role.

Unfortunately this does not at the moment look a very practicable proposal either, because it runs foul of the G-7's proscription on any transfer of risk from the private to the public sector. But I still nurture hopes that, with the backing of conferences like this one, the G-7 might concede the distinction between their quite proper resistance to an unrequited transfer of risk, and the highly constructive role that the public sector could play if it offered a risk transfer as a means of buying debt reduction from the banks. A major program of public sector guarantees or exit bonds by debtor countries that have put their economic policies in order--and there are now half a dozen, notably Chile, Colombia and Mexico among the larger countries, and Bolivia, Costa Rica and Uruguay among the smaller ones--would enable debt reduction to provide at least half a solution to the debt problem.

The other half is going to need yet another reconstruction of the debt of those banks that choose not to exit. It will require them to recognize the regrettable truth that the debt problem has no end in sight if we continue to insist that it can end only with a return to voluntary access to capital markets. We need to lower our sights and seek instead a situation in which the burden on the debtors' cash flow is cut to a level they can live and grow with under a wide range of contingencies; which eases the perverse incentive effects that can be engendered by a debt overhang; and which avoids the need for repeated debt renegotiation. My own candidate for a definitive debt reconstruction to achieve these objectives involves agreeing a formula based on export receipts that would place a cap on debt service payments, with automatic rollover of amortization and capitalization of interest in excess of that cap. (Perhaps other approaches would serve equally well.)

A definitive debt reconstruction for nonexiting banks, like World Bank guarantees for those that do wish to exit for a price, is an idea that is not immediately practicable. But their impracticability resides in the fact that there is not, at least as yet, a consensus favouring their adoption, rather than in the need to persuade the banks to abandon their self-interest or the G-7 governments to reverse the basic principles they have been proclaiming. I hope that today we can start forging the consensus that may before long bring these proposals into the realm of what is indeed practicable.

Representative **Obey**. Thank you very much.

I'm going to yield to Congressman Upton for his questions first and I will be back.

Representative **Upton**. Thank you. I have a number of questions that I would be most interested in hearing from you all.

First of all, going back to Mr. Hale's testimony, you talked a lot about the tremendous growth in the Japanese stock market, particularly relative to the stock markets of other countries, especially with this country.

How much of that is due to the greater attractiveness of Japan versus the United States and how much of it is internal to Japan? That is, is it more attractive to invest in the stock market than other uses of savings, et cetera? What are some of the different dynamics between this country and Japan that would be unique?

Mr. **Hale**. There is great controversy among analysts in terms of breaking down the various factors which have contributed to the tremendous bull market in Tokyo during the 1980's. But as I attempted to indicate in my statement, both written and verbal, I think that much of the appreciation can be put down to traditional macroeconomic factors like a high savings rate, swelled in the mid-1980's in particular by the export boom to America and by the collapse in global commodity prices, especially yen-denominated commodity prices.

For example, in 1980 Japan's oil imports were equal to 6 percent of GNP. Last year they were down to 1 percent of GNP. So you had a tremendous import cost savings coming as a consequence of global prices really beyond Japan's control. Japan obviously had some influence in the rise in the yen, but not on the dollar price of oil.

On top of that, Japanese industry is well organized, highly competitive, and enjoys a great deal of both direct and indirect support from the govenment in the way policy is conducted and the way the private sector is encouraged to create wealth, and this has allowed them to have tremendous profit growth.

There was, for a brief time in the mid-1980's, because of very low interest rates, a large rise in the price earnings multiples, from levels maybe of 20 or 25, to as high as 55 or 60, but because of tremendous profit growth, the multiple is now coming back to about 35 in 1989, which is still a high multiple, given the fact that their bond yields are close to 5 percent, but it is not as extreme or as outrageous as the multiples appeared to be 2 or 3 years ago when they were much closer to 60.

The final factor that I indicated in my testimony, the emergence of the market as an informal instrument of government economic policy is obviously very hard to quantify, but I tried to cite some examples in my prepared statement of valuation of bank stocks and their correlation with levels of cross-shareholding and with the very, very strong intent in the past couple of years on the part of both the public and private sector to see the banks recapitalized on attractive terms under our new bank of international settlement asset ratios.

There are new guidelines affecting all world banks but they were thought to be, initially at least, a special problem for Japanese banks because of their low traditional equity asset ratios as measured by historic cost accounting. And there I think you could argue that some of the rise in the market, some of the valuation discrepancy, maybe 20 percent or even 30 percent, is a function of institutional differences in which investors are willing to pay a very high price because they believe the overall institutional setting will be managed and guided in a way that will be conducive to continuing high valuation levels.

Two or three years ago, some people might have argued it would be even more than that. But I think that one could argue for a fair valuation of the Japanese market, maybe 25 or 20 compared to 35, and therefore that difference may reflect the interaction of these positive economic fundamentals with a divergence in institutional practices compared to the United States, England, and other traditional market economies.

Again, you would find great controversy on that point among various security analysts because there is no precise way to quantify it. We have disagreements about what drives stock markets in our country. But if you use traditional criteria for value, using a combination of earnings, interest rates, and dividends, multiples would still seem to be high in Japan, but in no immediate danger of coming down because the underlying factors—liquidity, profit growth, and government support for the market—are still very much in place.

Representative UPTON. Mr. Sachs, I was very interested in your comments early on with regard to new taxes. It's my understanding that the Bush budget, when it comes up this evening or late this afternoon, will of course, whether it's CBO or OMB, will show a rise in revenues in fact in the neighborhood of about $80 to $90 billion.

We're going to be seeing the Social Security tax, I know, go up a little bit more later this year. And I would be most interested to hear your thoughts on those new revenues that are coming about, as well as your ideas. I agree with you that we need to have more incentives for savings, personal savings.

As Mr. Williamson testified, there is, I think, some credence that us baby boomers don't have the assets to perhaps save like they can in West Germany and Japan.

I would be most interested in your comments on those two points.

Mr. SACHS. Not only are we both baby boombers, but we're both fellow Michiganites actually.

Representative UPTON. Oh, all right. Good. Go blue.

Representative OBEY. As a Badger, I won't hold it against either one of you?

Mr. SACHS. What was that, Congressman?

Representative OBEY. I said, as a Badger, I won't hold it against either one of you.

Mr. SACHS. I think that the notion that one rules out taxes beforehand as a way to do anything right now with the budget is an extraordinary abdication of responsibility. We have implanted in the minds of people that there is some macroeconomic disaster lurking at the door, another wolf at the door if we raise taxes, however slightly.

We routinely tell countries in Latin America, by the way, to raise 5 percent of GNP higher in taxes in a matter of 6 months or 1 year. We've come to the view here that you touch the tax side and you destroy the recovery.

I heard Senator Kasten on a talk show a couple of weeks ago, making what sounded to me exactly like what I hear in Latin America over and over again; that we just can't do anything on the tax side because our economy is so fragile, if we start to do it, it's going to be a disaster.

I think that the first thing we have to do is be honest intellectually about it. There are profound value choices to be made.

Representative **Obey**. In this town?

Mr. **Sachs**. Well, I'm going back this afternoon, so maybe I can take a little more leeway.

There are value choices to be made, for sure, about what kind of society we want to live in, and how we want the division between public and private responsibility and so forth.

But the first thing we ought to make clear is that this psychosis against taxes is without any economic basis and that the most successful economies in the world have a vast array of tax shares as a percent of GNP. The view that somehow we're locked in by macroeconomic determinants as opposed to value determinants, and so forth, seems to me to be something that we ought to have on the record and debate up front and be very clear about.

What I object to is this idea that we are dictated to do it one way or another.

Then I come down to a very pragmatic view, which is just as a citizen and someone pretty deeply steeped in the Federal budget, I don't think we can get enough savings in this economy without going the tax route.

What worries me, frankly, is not only the neglect of some of the Government's responsibilities at home, but what I see as a weakening of our international position in the world, which worries me greatly.

For instance, this international debt facility that I talked about has been costed out to require appropriations of the United States of perhaps half a billion dollars a year for a few years to fund a new facility at the World Bank. We're now told that's impossible.

Well, the Japanese have stood up and said, we'll do it. And we tell them no, you can't do it because then you'll want more voting shares and we're not going to let you do that either. And it seems to me what we are doing is, we are trying to play Super Power on the cheap, and we're trying to have it both ways. We're not willing to pay our way in the world, but then since we're not meeting our responsibilities, we don't want anyone else to meet them either because that's going to diminish our relative position in important matters.

I see that all the time in my work in the international organizations. I think that this is a crying shame for this country which has a great leadership role to play. If we were more up front and said $20 billion of gasoline tax increases would not do serious damage to this country but it might let us play a role in the world that the American people expect, I think that would be a very appropriate kind of response.

Representative **Upton**. My time has expired, and I'll come back. But the only underlying comment that I wanted to make was that despite the pledge of "read my lips," we're still going to see a large increase in revenues, hopefully the closing of—I don't want to say loopholes, but from the Tax Code that was from before, as well as the Social Security tax which really does hit all of us probably in this room.

Thank you, Mr. Chairman.

Representative **Obey**. Thank you, Congressman Upton.

Let me simply say I really think the whole town and the whole country is talking about this in terms that are really off base and totally wrong because we are all buying into the idea that there will be no new taxes. I fully agree that there will be no new taxes on top of the table. I don't think there's a chance of a snowball in you-know-where that the Congress will adopt 1 dime in taxes this year.

That doesn't mean that the tax-paying public isn't going to be paying additional taxes. I used to be a real estate broker. I have the old monthly payment book that I used to use to figure out what a mortgage was going to cost somebody. It's a little old fashioned because it doesn't go up above 10 percent.

And if I recall when my wife and I bought our first home, we paid 4½ percent interest. That was the only reason we could buy a home was because the interest rates at that point were that low, and it was also before the inflation in housing crisis hit a lot of markets in this country.

As I look at this old outdated payment book, if you take a home equity loan, which right now, by and large, they're going for about a point and a half above prime, adjusted anywhere from quarterly to annually. If you assume that someone takes out a line of credit home equity loan for 10 years to put a couple kids through college, what you find is that a 1-percent difference in interest rate on that $20,000 loan would be about $77 a month. So that is a tax which people are going to be paying. It has the effect of a tax. It certainly makes just as big an imprint on their pocketbook as one that is honestly applied to help bring down interest rates.

On a 25-year mortgage, that same difference in interest rates applied to long-term rates would be, on an $80,000 home, about $57 per month and, on a $100,000 home, about $70 per month. So we are extracting unneeded taxes from people right now, under the table, because this town is not, and I predict will not be honest enough to deal with the tax question on top of the table. I just wanted to make that little observation before I ask a few questions.

Let me ask you this, gentlemen. Here is what I think is going to happen tonight and throughout the year. It has not been generally perceived yet by the press or, for that matter, many Members of Congress, or certainly anybody else, but thanks to a court ruling we now have a different Gramm-Rudman than we had.

That means that if any incumbent administration sets its own economic estimates, no matter how goofy the Congress might think they are, we have no choice but to go along with them, because under the Gramm-Rudman sequester it is now OMB that decides what those numbers are in terms of hitting that wall.

So under original Gramm-Rudman before the court decision, the Congress might have been able to fight with the administration about economic estimates. We can't anymore, because OMB and CBO spells out what they think the growth rate will be, what the inflation rate will be, but what counts is what OMB says.

So here is what we're battling in the budget that's being sent down. Unless President Bush changes former President Reagan's numbers, we will be told that the real growth rate will be 3.5 percent in 1989, 3.4 percent in 1990. We will be told that the inflation rate will be 3.6 percent this year and 3.5 percent next year.

Good morning, Lee.

If we adopt those more optimistic economic assumptions as opposed to the assumptions that are generally agreed upon by private sector estimators, what that means is that the Congress will have to cut about $20 billion less in spending than it would otherwise have to cut if it was playing by CBO numbers.

And just one other point of explanation. That means that we will all be able to pretend in October when the new budget goes into effect that we have hit those targets, and so we will avoid sequestration because we will have followed the administration's estimates.

If those estimates prove to be correct in the real world, we'll be all right. But if they don't, next year we will wind up with a deficit, say, $20 billion larger than we told the country it would be when we passed the budget.

Let me simply ask you this question. If that happens, and I flatly predict that's what will happen, if that happens this year and next year, for the next 4 years, what would the impact be on the trade deficit in comparison to what that trade deficit would likely be if we were to really hit the Gramm-Rudman target for the next 4 years?

Mr. HALE. I think, as I indicated in both my prepared statement, the initial testimony, noncompliance with Gramm-Rudman would have the following effects.

First, this year, 1989, all the burden for restraining inflation will fall upon the Federal Reserve Board. We'll be talking about a Federal funds rate of not just 9½ percent this spring, which is the current consensus, but possibly by the autumn as high as 10 percent. That would mean a stronger dollar in the near term. The export growth rate would then slow in the second half of the year, and perhaps a stronger dollar would even encourage somewhat more import demand.

I don't believe the Federal Reserve would go so far as to cause a recession because I think that would generate all kinds of other problems with our banking system and so on. Therefore what the Fed will attempt to do is to finetune. But in the short term it could give us a somewhat stronger dollar, perhaps 135 yen, perhaps a deutsche mark of 195, maybe even something higher than that.

That would mean that in 1990 the trade adjustment would probably come to a halt, unless the Federal Reserve were to in fact go all the way and give us an out and out recession that would curtail domestic demand, causing a slump in sales of cars, consumer goods, and capital goods.

I think that this high-wire act, this balancing act could go on for several months. The overall effect would be to prevent our trade account from experiencing the $20 or $30 billion of improvement it ought to have in 1990 if we had substantive compliance with Gramm-Rudman. So we would, I think, see a grinding to a halt in the adjustment process and the danger would then increase renewed problems in the stock market and the bond market caused by high interest rates, and the fears of what that would do over time to our overall adjustment process.

Let me just add that the 5.7 percent Treasury bill forecast for 1990 would then also certainly only be credible if we were to start borrowing in yen as opposed to borrowing in U.S. dollars. So all of our budget assumptions would be blown out of the water, not just for 1990 but for the years that followed.

Representative OBEY. Mr. Sachs.

Mr. SACHS. I would give a similar answer. The key burden of my testimony was that we have to improve the budget balance in order to improve the trade balance unless, of course, the baby boomers get virtuous and start saving, which we can't really rely on in the very short term.

So clearly if we don't have an improvement on the budget, we're going to have a stall in the improvement of the trade balance, and we won't get that $60 or $70 billion that John Williamson talked about.

I would be worried as well that inflation will accelerate. I think we are on a knife edge right now. As I mentioned, the dollar has come down in anticipation of real improvements in the deficit. It's fallen almost 50 percent in weighted average basis. We have not had the full pass-through of that effect into domestic prices.

If we get some shocks on prices, if oil prices, say, reach $18 a barrel and stay there, some import prices jump up because they've been lagging the effects of the dollar, if we get some of those things happening we're going to see, quite quickly, inflation reach 6 or 6½ percent in this economy. And I think at that point, the Fed will tighten up and throw us into a recession in 1990.

I would mention that every Republican administration since the postwar, actually since 1920, has started with a slowdown in the first 2 years of the administration, and every Republican administration except for the period 1985–86 has started with a recession sometime in the first 2 years of the administration. And that's usually because there is a conservative inflation fighter in the Fed and, for whatever reason, either mopping up the inflation from a previous Democratic administration or whatever reason, they start tightening up.

I see that as the most important short-term risk for the macrosituation. I think we ought to take that seriously. It is clear that Mr. Greenspan takes it seriously, and so do I. And I would expect that if we reach a political threshold of 6 percent annualized inflation for several months, we're going to see a tightening up enough to put us into at least a small recession.

Representative OBEY. Mr. Williamson.

Mr. WILLIAMSON. I think I endorse just about everything that's been said before. Let me just make one qualification. As I understand your alternative scenario, each year that the Gramm-Rudman target gets missed by $20 or $30 billion——

Representative **Obey**. I'm assuming that we follow Mr. Bush's prescription to a T. No new taxes on top of the table, just the taxes that are represented by the increase of 200 basis points that we had last year, for instance, and that a year from now we will find out then that we would have missed Gramm-Rudman by $20 billion, and I'm assuming there will still be no new tax posture and that we'll play games with Gramm-Rudman targets like that for the next 3 years, as we did for the last 3 years.

Mr. **Williamson**. The element of ambiguity is whether you assume that next year, when one starts again, one will keep the old Gramm-Rudman target and then miss that by $20 or $30 billion next year, or whether one will in effect modify the target so that one won't make any further progress.

Representative **Obey**. Well, in the past they've been modified. I assume that that's what would have to happen this time.

Mr. **Williamson**. If in fact the targets get progressively modified away so that no further progress is made, then it seems to me one can't expect any further progress on the trade deficit without a recession. If, on the other hand, one simply missed it by a constant $20 or $30 billion, then one would miss out on 1 year's progress but could resume after that. I think the former would be a disaster. The deficit would stay as large as it is basically.

Representative **Obey**. Thank you.

I think I've defined what the result will be, because I am convinced Mr. Bush will get his way, totally. And so I guess at the end of the year, we will see. But if your prescription is right, 1990 doesn't sound like a very good year for the Republican Party. Maybe that's the best reason for following Mr. Bush's advice.

Let me ask one other question. I know my time has expired, but I am going to have to leave for another committee meeting. The chairman is here.

On Third World debt restructuring, Mr. Sachs, you indicated, I think it was you—yes, you both made the same point—you suggest that it is very much in our own economic interest to now allow the money center banks who have lent large amounts of money to Latin America and other places to continue to in effect define our international economic policy with respect to Third World debt.

If we were to pursue—just two questions—if we were to pursue a policy that did put greater pressure on the banks to participate in some kind of effective debt relief, if we departed from the Baker plan and moved toward something closer to the Bradley plan, for instance, how would you answer the charge that's often made that, look, you simply had lots of high-income people in Brazil and every other place just put their money in Swiss bank accounts. Why in God's name should we support the kind of debt relief which lets them off the hook? That's what you are doing if you support that kind of prescription.

And a secondary question to that which some people would raise is if we do set up some kind of facility, the World Bank, for instance, as you're questioning, or if we have World Bank/IMF participating in some kind of guarantee scheme, isn't that simply taxing the world's taxpayers, including ours, in order to help these large banks with their own bank balances, in effect reflowing American taxpayers through these international institutions right back to the banks?

Mr. SACHS. If I could take the second part of the question first, my fear has long been that we are going to the taxpayers in a hidden way in order to keep the banks whole.

I think that debt relief is the best way to protect the taxpayers. What's happened is that as the debt has become so large, the official creditor community has found ways to channel money into these countries which they use to pay interest to commercial banks. So we have a highly sophisticated laundering operation underway right now, of taking taxpayer money in and putting it back into interest payments to the commercial banks.

When you dealt with the GCI last year, Congressman Obey, I am a great supporter of the World Bank and I admire the institution, but I was very much against the GCI at that moment. I regarded that as a flagrant bailout of the banks because that money is basically earmarked for interest payments right now, large loans to Argentina and Brazil and Mexico and a few others to help pay interest to the commercial banks.

The Paris Club right now, which is the bilateral government-to-government creditor club, takes no money from the debtor world right now basically. When you go to the Paris Club, you reschedule 100 percent of interest due and 100 percent of principal. Why is that? Because in the term sheet for the banks, what is left of the money that the countries don't have to pay back to the U.S. Export-Import Bank, for instance, then becomes available to pay the commercial banks.

We're in this together. If we try to keep the banks whole in this process, we are going to end up bearing the costs.

Now, I've studied in some detail and wanted to leave for interested members of the committee an analysis of how much a debt facility would actually cost the taxpayer.

The point of a debt facility is that the banks take losses, not the taxpayer. The taxpayer guarantees what remains after a subtantial reduction of the debt. And, by the way, the Japanese have sent signals all over the world, in every way they can, that they would bear the vastly disproportionate share of those guarantees.

I am fond of pointing out that the total secondary market value of all the bank debt at stake right now is worth 60 acres of downtown Tokyo. Tokyo land is pretty expensive, but the Japanese could take some of their J&R holdings right now and commit them as a mortgage to loans to guarantee a debt facility.

This is not going to be costly to the taxpayer. Under reasonable costs, it is about the cost actually to take care of the debt of the 30 largest debtor countries. I think it would cost the U.S. taxpayer about $500 million a year for 4 or 5 years to capitalize a debt facility, and that's about our annual aid to El Salvador, and I'm talking about solving the Mexican, Brazilian, Argentine, Ecuador, Peru, and Philippine problem.

We need to do this, and it's very cheap to do it, and the reason it's cheap, it's not the taxpayer bailing out the banks; it's the banks accepting some realism on these losses. And that's why it is so important to do.

On the other question, I was asked the same thing by Senator Gramm yesterday, testifying in the Senate Banking Committee. He said, we know that it was economic mismanagement that did this—and there is truth to that—but I also suggested to him that he knows very well in Texas that it was also high interest rates and an oil collapse that bankrupted half of his State's banking system. But he happens to live in an economy where he can call on Massachusetts taxpayers to bail out his banks, and I'm happy to do that. We're part of the same country.

It's a variety of shocks that did it—some bad economic decisions, some capital flight that was supported by our banks. This money did not go to Swiss bank accounts. It went to New York bank accounts, remember. When capital was flowing out of Mexico in late 1981 at an incredible rate of $5 or $10 billion in 3 or 4 months, Citibank and others tried to dissuade Mexico from devaluing at that point, saying come on, you still have a credit line here; don't worry about it. Everybody knew what was going on.

I regret the fact that a lot of this debt was incurred by military dictatorships, unconstitutional de facto governments, and the debt now has to be borne by democracies in this region who have inherited this incredible mess that was created by the banks and these former de facto governments.

And so partly to sustain the democracies, it's important to recognize who actually got us into this problem.

One last point. I, like everyone else in this issue, believe very strongly that any debt reduction has to be predicated on major economic reform programs, and that's why I'd like to see this facility lodged in the IMF and the World Bank. I believe in those institutions. They do a damn good job when they're not out acting as sheriff for commercial banks but, rather, trying to promote economic reform in these countries. And we ought to predicate any debt reduction on reform packages in these countries.

Mr. **Williamson**. Could I address briefly both of those points? On the question of taxpayers helping bail out the banks, it seems to me one has to draw a fundamental distinction between the type of guarantees that have traditionally been discussed, where the institution guarantees a new loan that the commercial bank makes and thereby enables it to get out a whole loan that presently isn't whole at the end of its 5- or 10-year term, which I think it is quite legitimate to call a bailout; and, on the other hand, providing a guarantee which is given in return for the bank's taking a loss—enabling them to get a secure exit, but by taking some losses up front. The latter type of operation seems to me much less open to objection.

That's not to endorse the feasibility of solving the debt crisis for half a billion dollars a year. If it was that easy it would have been done long ago. But it is to say that there is a role for putting some money—and preferably getting some Japanese money, which probably would be feasible—in the international institutions, and using it. We have a disagreement on whether it's feasible to do it across all banks or whether we should concentrate on the banks that want to sell out and help them get out, which is my position.

On the other question of capital flight and policy reform, it seems to me that we ought at this stage to be making a major change in policy. Certainly one doesn't want to start giving relief indiscriminately. But I think it's time that we questioned whether it's a very effective strategy to always make countries come in and promise to change their habits in the future. It seems to me that we now have a number of countries in Latin America that have actually done the policy reforms, and that we ought to concentrate on rewarding those countries by making this type of operation feasible there, thereby giving an incentive to the other countries to come along and put in efficient policy reforms as well.

Mr. SACHS. I concur with that last point.

Representative OBEY. Thank you very much. I have to go to a caucus. I appreciate the testimony of all of you.

Mr. Sachs, I wish some of the members of my subcommittee could hear you on that. In fact, I may try to arrange that.

Mr. SACHS. I would be delighted.

Representative OBEY. Mr. Hale, I found your statement to be especially intriguing. I thank you for your time. I thank you all.

Representative UPTON. Mr. Chairman, I've had some questions already.

Representative HAMILTON [presiding]. Go ahead.

Representative UPTON. I just have one further question that I'd like to have all of you respond to. We've talked quite a bit about Gramm-Rudman today and about trying to reduce our domestic deficit, which I think all in Congress, on both sides of the aisle, would like to do and to comply with the Gramm-Rudman targets.

But as I look back as the last session of Congress, the 100th Congress, the one big trade issue that we dealt with, of course, was the trade bill, a bill that I supported. I think that many overseas perhaps viewed this as somewhat protectionist. It was regarded as a free but fair bill. The Gephardt provision was eventually stripped out in conference.

But as we look to this session of Congress, there has been some talk about renewing the trade bill debate, perhaps making it a little bit tougher. And I would like to know what your suggestions would be, and ramifications of those suggestions as we look to the next 12 to 14 months as to its impact on the trade deficit, if in fact we did toughen up another trade bill and what suggestions you might have--whether it be walking away from such a bill or not.

Mr. WILLIAMSON. I think I agree with what Professor Sachs said at the beginning of his testimony; that trade legislation cannot be expected to have a major impact on the trade deficit, especially now that the economy has reached full employment. The extent to which the trade deficit improves is going to be constrained by the extent to which macroeconomic policy makes room for that improvement.

Another trade bill, even if it does open foreign markets rather than close U.S. markets, would not create any presumption of a major effect on the trade deficit.

Mr. SACHS. I would agree with that. Trade policy should be viewed in terms of promoting exports and so forth, but not as something that's going to have a material effect on the trade balance per se.

I think we would do ourselves a lot good if we first recognized that point and admitted it, and then that would lead us to some greater wisdom in focusing on where the trade actions should be. We do have a lot of legitimate complaints, it seems to me, about Japanese trade practices. But it's not the across-the-board closed society kind of problems that we hear when we say $60 billion bilateral deficit and so forth. That's the main point.

Where the Japanese are particularly harmful to us, it seems to me, is in restricting our access to their markets for high-tech goods where we do have a clear comparative advantage. Our firms have, in the past 20 years, had to wait a long time to move our goods in, and could only come in under licensing agreements that generally transferred technology in a way that was disadvantageous to the United States.

That and agriculture are two areas where I think we have very legitimate gripes against the Japanese. I would make clear, though, getting those straightened out would be for America's benefit. We ought to work hard on that. We ought to be very well directed and well focused, but we ought not pretend that that's going to change the net trade balance in any material way, recognize that as a macroeconomic fact.

The reason I stress that so much is that I feel that we're pounding on Korea right now because we dare not pound on Japan, but we have all of these frustrations that we have to get out of our system. And Korea is one of the most successful and thrifty countries in the world; I have great admiration for what they've done in one generation, accomplishing transformation of their economy from a premodern state to a modern economy. I think it is enormously to the benefit of the world and our strategic benefit as well as to the benefit of the people there.

I strongly object to banging on them because of these numbers on the bilateral trade. I don't think true analytical work can support that kind of emphasis and we ought to be extremely careful with doing it that way.

I spend a lot of time in East Asia. My sense is that we don't do it against Japan because we're terrified they're going to cut off the credit flows to us. It was easy to pound on Japan when we didn't depend on them so much. Now we restrain our rhetoric because the last thing we need is a financial crisis. So we pound on Korea because that's the new Japan, and they don't lend us so much money to make us vulnerable.

So I would just stress to be careful, dignified, and serious in our relations with our partners, and recognize the very limited areas where it is important to be effective, and not the broad-brush kind of measures that say if our imports are three times our exports, that is a prima facie case for anything. It's a prima facie case for our low savings rate. It is not a prima facie case for taking discriminatory action against them.

Mr. **Hale**. Let me just add that, as I indicated in my earlier testimony, I agree with the other speakers here that macroadjustment is the major theme for 1989 and 1990. The new trade bill of 1988 is quite sweeping, quite comprehensive. I don't think in the industrial and manufacturing area we need any new legislation.

As I indicated in my testimony, I think in the financial service area we should have additional discussion and investigation of the role the Tokyo market is playing, as well as the possible impact it could have on global market share for banking and various financial service in the 1990's.

But here I think we need study and research, not new legislation. Maybe legislation would follow in a year or two, after we have a better handle on our own domestic framework for financial regulation, given the changes we are about to have in our securities markets and banking system.

Just to magnify what Jeff Sachs said about Korea and Taiwan, I was in Taipei about 10 days after a trip through Tokyo, and I was struck by the extent to which the adjustment process there now will be driven by labor shortages and by wage inflation. As indicated in my earlier comments, the great liquidity bubble there coming out of their trade surpluses is now fueling tremendous wage inflation.

This year we will see 10 and 15 percent growth in base pay in Taiwan. And bonuses, which are an important part of compensation in that society, may be 4 or 5 months of pay, not the traditional 1 or 2 months. So Taiwanese businessmen are very concerned that on top of this huge rise in their effective labor costs, they would now also be hit by trade restrictions as well as forced revaluation of the Taiwan dollar.

It may be appropriate at some point to encourage another revaluation of the Taiwan dollar. I simply have not enough microeconomic information to say how much these wage changes will alter their trade balance without any further policy change elsewhere.

But clearly the marketplace itself, with the country having effectively full employment—some would even argue negative unemployment—with thousands of unfilled job vacancies, is going to have a major impact on their trade balance, their import demand and their economic performance over the next 2 or 3 years. And we should be sensitive to how far this is going through market channels without additional policy actions.

Mr. SACHS. Could I add one more thought? 1992 is a big issue in Europe and a big issue for us in terms of trade policy. I, I think, share the mainstream view—well, I don't know if it's the mainstream view—I take the view that 1992 is not primarily motivated by protectionist impulses. But I do believe that if we are not vigilant, that there could be a lot of protectionism built into the regulations in the fine details in the next couple of years.

It seems to me that congressional scrutiny of the details of 1992 would be very useful for us in making sure that they don't get off track. There are enough forces in Europe that would like to make some protectionist measures, and I think that while that is not the motivation, it is a risk unless we are very vigilant in watching closely what's happening. And I think that Congress is obviously an excellent forum for paying close attention to that process.

Mr. WILLIAMSON. If I might just add one gloss on that, I think it is also true that there are sufficient forces in Europe against turning it into Fortress Europe to have some valuable allies there in heading off the danger if indeed the negotiations are followed in detail, as Jeffrey Sachs is suggesting.

Representative UPTON. Thank you.

Representative **Hamilton**. Thank you very much, gentleman. I know you've been at it for a while here, and we'll try to wrap it up fairly quickly. I would like to cover a few areas with you.

Mr. Sachs, one of your phrases a moment ago really caught my ear: We were terrified that Japan would cut off the credit flows.

That raised in my mind the whole question of foreign influence or control over the U.S. economy today. And I would like to get your general reactions to that.

Do they have the power, Japan for example, to determine whether or not the United States economy goes into recession?

Mr. **Sachs**. Japanese policies clearly have a lot of influence on our economy now. They are the major support for the capital inflows into the United States. Those are driven by economic factors primarily, but they are also driven by Japanese Government policies and also by private sector perceptions in Japan of Japanese official views of the situation.

At crucial moments when private capital did choke up a bit coming to the United States, the Bank of Japan did take over the financing role for some short intervals. So those were clearly episodes where they did have the potential to create problems for the United States.

Representative **Hamilton**. Is this something we really have to start worrying about here?

Mr. **Sachs**. Well, I think that like all of the rest of the world, we're learning that we are subject to interdependencies. And I do believe very strongly, although most economists don't share this view and it's hard to quantify, I believe that as a net debtor country and as one dependent on capital inflows, we do give up a lot of our sovereignty and we become increasingly unable to lead effectively in terms of strategic considerations and so forth.

Representative **Hamilton**. Mr. Hale, do you have a comment on this?

Mr. **Hale**. Yes.

I would say that right now the financial markets are very sensitive to what could happen under the new trade legislation. I discussed with a money market economist yesterday from a prominent New York bank what he thinks will be the major events in the market in the second and third quarter of this year.

He gave the usual suspects—the inflation rate and interest rates—and then he said super 301 actions. Will there be some trade action by our government that will lead to "financial retaliation"?

I assured him that as far as I knew, all of our trade actions will be directed, as Jeff Sachs indicated, against Korea and Taiwan, which would not have the same capacity to generate financial retaliation, as would a trade action against larger countries.

As I indicated in my prepared statement, there was not time to cover it in my opening comments, I think that the Japanese Government over the last 2 or 3 years has been engaged in a tremendous effort to help the United States by using central bank intervention, by using government moral suasion over private investors, and by having monetary policy itself pursue an expansionary track, to help smooth out our adjustment process and prevent a hard landing or deterioration that would lead to a recession in this country.

Whether they will become more aggressive and more combative in the future will depend obviously on our economic policies, our trade policies, and the whole nature of the United States-Japan relationship.

Representative HAMILTON. Could they become so good at that that they could manipulate the result of an American presidential election?

Mr. HALE. Well, I think that they have the capacity to make for a more benign financial environment from time to time if they chose to and, conversely, to perhaps make the financial environment less benign.

Whether that would be the driving influence on policy would depend obviously on many other factors and variables. But, in my mind, and I think the behaviour of the financial markets last year will validate this, there was a perception in the marketplace that during 1988 that certain central banks, especially in East Asia, would play an active and supportive role in our financial markets to maintain a sense of prosperity and financial tranquility.

And the fact that the dollar fell sharply in the days right before and right after the election indicates that private investors themselves organized their own portfolio decisions around the perception that we would have support for our currency at least through November 8.

Now, since that time, various Japanese officials have been to Washington to indicate that they want a strong American economy in 1989, and therefore there will be continuing support for our dollar even if we don't get the new policy mix initially right. Whether that will continue beyond 1989 obviously we don't know.

My sense is that Japan needs a strong and stable America for some time and therefore will not easily or quickly abandon the support we've seen over the last 2 years. This will be a continuing process.

Representative HAMILTON. Are there other countries that have that kind of an impact?

Mr. HALE. I think that other countries play a part in the process, but not nearly as important as Japan, for a variety of reasons.

First, Japan is now the world's largest capital exporter; on a scale of $80 to $90 billion per annum.

Second, in the next 24 months, Europe as a whole will be in current balance. There's a big surplus to be sure in Germany, but it's now offset by large deficits in Britain, France, Spain, and smaller countries in Europe.

So, in a sense, we will be far more dependent on Japanese capital flows in the next 2 or 3 years than we have been so far in the 1980's because they will be the last remaining big external saver especially if, as I suggested earlier, the surpluses in Taiwan now shrink quite dramatically because of an import boom from Japan and other countries.

In addition, the Japanese financial markets are organized differently. The role of the government is far larger in the financial process there than it would be in this country through a mixture of moral suasion and the use of credit controls from time to time.

The fact is, the Japanese central bank has powers that would not be comparable to the powers of the central bank in this country or a European central bank like the Bank of England. We could use those powers under law, but we have not used them in many, many years.

So I think there's a perception again in the market place that that power is of an order of magnitude, again given the different institutional setting there, that their capacity to influence events would be greater than for a central bank in Germany, Italy, or elsewhere in the world.

Representative **Hamilton**. We are very dependent today on foreign capital. Spell out for me how that constrains Federal Reserve policy. What are the implications of that so far as the Federal Reserve is concerned?

Mr. **Hale**. Well, if the Federal Reserve is concerned about inflation, it would obviously have to be very sensitive to whether any policy action it took would cause a drop in the value of the dollar which would add to our domestic inflation pressure.

Second, if we were to have an absence of private capital inflows, then our interest rates would tend to rise unless the central bank itself was going to come forward and basically buy the debt, either the public sector or the private sector.

So I think that it would be argued, and I think you ought to ask Jeff Sachs and John Williamson to give their opinions on this as well, that we have a new constraint on policy; that we must be sensitive to foreign investor confidence because of the potential impact of a change in private capital flows from overseas, on demand for our financial instruments, and therefore on our interest rates, and therefore on the tradeoffs facing our central bank in trying to find a policy mix.

Representative **Hamilton**. I'll ask the others. But would the increase in short-term interest rates that we've had over the last 10 months or a year, has that been a factor do you think in the Federal Reserve's decision?

Mr. **Hale**. I think the most important factor last year driving up interest rates was the sense that our economy was so strong, we would have to have higher interest rates in order to ration output growth and prevent economic overheating.

But also in the back of their mind was the awareness and the perception that if we did not take action to make sure that our inflation rates was not going to escalate significantly, that we would in fact have foreign investors being concerned about inflationary overheating and have the kind of capital flight from the dollar which occurred during the Carter administration, when our policy failed to meet the challenge of rising inflation and therefore frightened investors—not in that case Japanese investors, more European investors and Arab investors—into selling dollar financial assets.

So the dollar was part of a larger concern, Congressman, which encompasses inflation and the overall financial balance. But it was not insignificant. It just can't be separated. It was part of a larger process.

Mr. **Williamson**. I think I would disagree that in recent months the rise in the interest rate has been in any way due to the foreign dimension. In fact, I would say the contrary. I think one thing that restrained the rise in interest rates was the fear that the dollar would bounce up further as interest rates rose. Another thing, I hope, was concern about worsening the Third World debt problem.

So those were factors that were probably to some extent restraining the rise in interest rates, but nevertheless, because the internal economy was so strong, it was necessary to go ahead anyway.

I would also say on this issue that I don't think there's anything very new about the interdependence on the financial front. That's something that has been developing gradually over the last 20 to 25 years. What is new in the last few years is that it has finally been recognized in the United States. In the early 1980's it was ignored, which is why the dollar went through the ceiling. And now, thank goodness, it's being taken into account. It is good that the United States is now recognizing this interdependence, but it doesn't make the United States different from any other country. It has come into line with other countries in that respect.

Representative HAMILTON. How do you feel about the policy coordination taking place in the G7? Is that a process that's working pretty well, and is that a process that ought to focus, as it apparently has, on the value of the dollar, or should it focus on other things?

Mr. WILLIAMSON. I think one of the major things it should focus on is the value of the dollar. I think it should also focus on the strength of the growth of demand in each of the countries. To some extent they are beginning to do that, but they don't have it, in my view, in a sufficiently systematic form.

I welcome the process as far as it has gone, but I would like to see it go further yet.

Representative HAMILTON. In what way?

Mr. WILLIAMSON. I'd like to see a set of guidelines for rational policy conduct agreed among the countries in advance, and then each country judged as it were by the extent to which it was conducting both its monetary and its fiscal policy so as to achieve these outcomes.

Representative HAMILTON. You really want a lot more coordination, don't you? I mean you want coordination among the fiscal and monetary policies of the countries, right?

Mr. WILLIAMSON. Right. And this is a way to get that.

Representative HAMILTON. Now, today it's more or less focused on the question of the value of the dollar; is that correct?

Mr. WILLIAMSON. The major focus in terms of action has been on currency values, but in principle they have a whole set of indicators which they look at. It's not clear that the rest mean very much.

Representative HAMILTON. Let me ask a general question to you, jumping around here quickly because of time. That's the whole question of industrial policy. I know, Mr. Hale, you've written a bit on this.

But I picked up the paper the other day and I read about high-density television and how we're getting into that and we're doing it through the Defense Department, and we have to get into it because we have to be competitive there. So that's an industrial policy, at least as nearly as I can remember the definition of it. We have also Sematech.

You pointed out that Japan's rise and success has been due to its industrial policies. Now, is it your view—and I ask the panel this—that in order for the United States to be competitive in the world, that we have to change rather sharply the way we do business and begin to adopt an industrial policy and have a Sematech and have a high-density television over here, and give some breaks to the semiconductor industry and all of these things? Is that the only way we can be competitive in the world?

How do you feel about that? Is that a good trend or a bad trend?

Mr. **Hale**. First let me just add some qualifications. I indicated that Japan had used industrial policy effectively within the context of a whole set of policies, macro and micro, that were conducive to a high level of savings and investment, and that the role of government was not to prescribe investment but to be prescriptive in the sense of serving as a catalyst for the private sector to pursue various kinds of ventures that might not have been pursued elsewhere because of the risk or high capital cost.

I think that there will be a role in the next decade for industrial policy in this country because, whether we call it industrial policy, we already have one. We have a mixture of depreciation policies, exchange rate policies, and other policies which have a major influence on industry.

Where we part company with Japan and some European societies is we don't pursue these policies self-consciously. We just take for granted that we have these policies and don't think through how they will interact and affect our industrial competitiveness.

So I think if we are going to be effective in the 1990's in meeting the challenge especially posed by East Asia, which recognizes that in a high-technology age, comparative advantage is not a function of random forces but in fact of conscious state policy affecting everything from interest rates to educational systems, we also will have to be more self-conscious and organized.

And I think the catalyst for that has to include a sensible macroeconomic policy from the standpoint of encouraging savings and investment as well as a more effective coordination of the agencies in Washington, like the Commerce Department and the Pentagon, which often have a major impact on the allocation of resources especially for defense technology and high-technology capital goods.

Let me just add that, again in contrast to Japan, we have the problem that we have not hitherto, at least in the modern period, tried to develop the kinds of industrial institutions that have conducted effective policy in Japan. We don't have, for a variety of reasons involving Federal pay and the way our culture operates, the kind of civil service that you find in the Japanese Ministry of International Trade or the Ministry of Finance to preside over successful industrial policies.

So if we are going to embark on this new direction, if we are going to be more effective in this area, we will have to have a mixture of changes that I think go beyond just "having an industrial policy." They would require a new institutional arrangement in Washington itself to have the Government be an effective player.

The current mixture of institutions we have in this area would not in my opinion be effective, and might actually give us the bad aspects of European industrial policy rather than the benign and positive aspects of Japanese industrial policy which now generates so much envy and excitement over here.

Representative **Hamilton**. I was just informed a moment ago that we are supposed to exit this room at this point in time. I didn't know about that.

Do you have any comments you want to add very quickly to what he said, and then we'll conclude.

Mr. **Sachs**. I agree with some of it. I would probably not go as far as David Hale did at the end. I think it's important not to be too dogmatic on this issue. It's clear we've had industrial policy in the military sector for four or five decades.

For major R&D expenditures, it's probably useful in some cases to have a national industrial effort. We recognized that a long time ago for military research and development and so forth, space exploration and so forth. And I think that that extends to other areas clearly.

I would just stress that one major thing that we can do to improve our performance, it is clear, is to gain access to the Japanese market at an earlier point for our high-tech innovations. Industry after industry, it really is true that through restrictions they have limited our access, gained time to gain the technology and competitiveness and so forth, and I think we ought to focus on that area in our negotiations with the Japanese.

Representative **Hamilton**. Mr. Williamson, a quick comment.

Mr. **Williamson**. I think there is a real problem with U.S. industry in terms of the short-term time horizon, but I am not at all convinced the answer to that is anything that goes under the name of industrial policy.

Representative **Hamilton**. Gentlemen, thank you very, very much for your cooperation this morning. It's good to have you with us.

We stand adjourned.

[Whereupon, at 12 noon, the committee adjourned, subject to the call of the Chair.]

[The following written questions and answers were subsequently supplied for the record:]

RESPONSES OF JOHN WILLIAMSON TO WRITTEN QUESTIONS POSED BY REPRESENTATIVE UPTON

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March 6, 1989

Dr. John Williamson
Institute for International Economics
11 Dupont Circle
Suite 620
Washington, D.C. 20036

Dear Dr. Williamson:

Following the Joint Economic Committee's hearing of February 9, 1989, Congressman Fred Upton asked that I submit four additional questions to you and the other witnesses. If you would respond to any or all of the following questions, I would appreciate having the answers which I will forward to Congressman Upton and insert in the hearing record. The questions follow:

1. We have heard many economists talk about the need for a "target zone" for the dollar, arguing that it would encourage investment by U.S. export industries through public reassurance against a renewed dollar appreciation. Last year, however, Paul Krugman of MIT told this committee "as along as we try to defend an unrealistic exchange rate, we are positioned for financial panic whenever bad trade news comes in."

a. How do we know if the target zone is realistic?

b. Is it possible for central banks to defend an unrealistic exchange rate for long?

2. A number of economists, including Fed Chairman Greenspan, now believe the trade deficit will continue to decline in the coming years without a further reduction in the dollar. Mr. Greenspan has cited strong foreign demand evidenced by export orders surpassing the current level of exports.

a. Do you agree that this scenario is possible?

b. If so, can you please describe what would be the likely outlook for the economy if there were no reduction in the budget deficit?

3. Congress will be considering a number of bills that attempt to give the government greater supervision over foreign direct investment in this country. What is your position on this issue?

4. If you were in the position of prescribing one or two major trade policy steps for the incoming Bush Administration, what would they be?

Again, thank you for testifying on February 9, and I look forward to hearing from you.

Sincerely,

Lee H. Hamilton
Chairman

INSTITUTE FOR
INTERNATIONAL
ECONOMICS

11 Dupont Circle, NW, Washington, DC 20036
(202) 328-9000 Telex: 261271 IIE UR
FAX: (202) 328-5432

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March 21, 1989

Honorable Lee H. Hamilton
Chairman
Joint Economic Committee of the
Congress of the United States
SD-G01 Dirksen Senate Office
Bldg.
Washington, DC 20510

Dear Mr. Hamilton:

Thank you for your letter of March 6 inviting me to respond to four additional questions from Congressman Fred Upton following the hearing at which I testified on February 9. I am pleased to enclose my responses.

Yours sincerely,

John Williamson

John Williamson
Senior Fellow

Enclosure

Responses to Questions from Congressman Upton
(Joint Economic Committee)

John Williamson

1. Target Zones

Near the end of my testimony, I suggested adoption of a target zone for the dollar, precisely on the argument that this would encourage investment by US export industries through providing them with reassurance against a renewed dollar appreciation. I am therefore pleased to have the opportunity of answering questions on this topic.

I agree with Professor Krugman's view that it is a mistake to defend an unrealistic exchange rate. One implication is that it is important to adopt arrangements that minimize the probability of a target zone becoming unrealistic. That is the purpose of proposing (i) that nominal target zones be revised regularly in order to neutralize differential inflation, and (ii) that real target zones be revised promptly in response to long-run real shocks to payments positions or new information about the outlook for the balance of payments.

(a) The question of identifying a realistic target zone is, of course, a difficult one--but not so difficult that it should not be attempted. In fact, my original study calling for target zones (The Exchange Rate System, first published by the Institute for International Economics in 1983) attempted to calculate target zones for the five major currencies, and I am currently undertaking a new study designed to refine and update those calculations. In brief, the basic notion is to try and identify a "fundamental equilibrium exchange rate", defined as the rate consistent with simultaneous achievement of noninflationary full employment at home and a satisfactory balance of payments position in the medium term, and make that the center of the target zone. This requires identifying levels of output corresponding to noninflationary full employment in the major countries, establishing a set of consistent, sustainable and satisfactory balance of payments objectives, and then applying an appropriate global macroeconometric model in order to calculate the implied set of exchange rate trajectories that would reconcile these objectives. The results of such an exercise can only be approximate, especially after a period of wide fluctuations of exchange rates, which is why it would be unwise to make target zones anywhere near as narrow as the EMS bands. But I believe that they can give reasonable assurance that a target zone need not be such as to lead to defense of an unrealistic exchange rate.

(b) It is unlikely that a central bank could successfully defend an unrealistic exchange rate for long, certainly not without severe costs. But, as illustrated by the preceding discussion, the design of the target zone proposal has aimed to minimize the probability of a central bank being asked to defend an unrealistic exchange rate.

2. The Dollar and the Trade Deficit

(a) As stated in my testimony (p. 5), the conventional models that lead to the expectation that the trade deficit will increase again in the next year or two do not capture the long-run supply-side impact of exchange-rate changes. It is possible, therefore, that the trade deficit will fall in future years even without a further decline in the dollar. However, it seems unlikely that such reductions will outweigh the increasing interest cost of servicing the mounting US foreign debt, so that the current account would at best remain roughly constant without further policy changes. A level of current export orders in excess of current exports provides little guidance on the likely medium-run trend.

(b) If the trade deficit declines and the budget deficit does not, the result is likely to be a further intensification of inflationary pressures. I presume that the Fed will respond by progressively raising interest rates, a process that is likely to end in a recession.

3. Foreign Investment

I see no advantage in changing present policy: this is an instance in which neglect is truly benign.

4. Trade Policy

As I stated in oral testimony, I do not believe that trade policy has any role to play in reducing the balance of payments deficit: that depends on macroeconomic policy, especially on a lower budget deficit. However, trade policy has other roles to play.

The two trade policy initiatives that I would most welcome would be unilateral liberalization of sugar imports and a willingness to negotiate major liberalization (or even abolition) of the Multifiber Arrangement within the Uruguay Round. Both initiatives would be advantageous to US consumers, would help restrain inflation, provide a big help to Third World producers and hence indirectly a stimulus to US exporters, and constitute an impressive demonstration that the United States has not lost the self-confidence to act rationally on trade matters.

THE 1989 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 22, 1989

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 11:04 a.m., in room 628, Dirksen Senate Office Building, Hon. David R. Obey (member of the committee) presiding.

Present: Representatives Obey, Scheuer, and Upton; and Senators Sarbanes and Symms.

Also present: Joseph J. Minarik, executive director; and William Buechner, Judith Davison, and Christopher Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, PRESIDING

Representative OBEY. Good morning.

Let me start by making clear that I am not Congressman Lee Hamilton. Chairman Hamilton is required to take care of another little matter of civic duty today. He is testifying in the Oliver North trial and very much regrets the fact that he could not be here. But I'm sure we all understand that that is a higher obligation that he has to fulfill.

I told the story, I had to stand in for him chairing a hearing a week and a half ago, and I told the story then and I'll repeat it—it reminds me of the time when I was in the legislature and the Governor was supposed to speak to an American Legion Convention. And at the last moment he couldn't speak, and so he asked me if I would stand in for him. When I did, so help me, the fellow who introduced me said, "Well, as you know, the Governor was scheduled to address us. He can't do that. And so it's with a great deal of regret that I give you Assemblyman Dave Obey." I think that's the situation we're in this morning.

This morning the Joint Economic Committee is very pleased to welcome the Honorable Michael Boskin, new Chairman of the Council on Economic Advisers. The JEC and the Council on Economic Advisers were both created by the same act of Congress, the Employment Act of 1946, and for the same purpose: to provide the President and the Congress with the best possible advice on the economy and economic policy.

I suppose it's fair to question whether either of us have fulfilled that role from time to time, but nonetheless that is our responsibility. The two institutions have had a long and fruitful history of working together to achieve that goal and the committee looks forward to continuing that work with Mr. Boskin during the 101st Congress.

At this time each year, the Joint Economic Committee conducts a series of hearings to review the President's annual Economic Report and to help us prepare our own Economic Report to the Congress as required by that Employment Act of 1946.

Earlier this year, the former CEA Chairman, Beryl Sprinkel, presented the 1989 Economic Report to the President, President Reagan's last Economic Report to the committee. Since Mr. Sprinkel's testimony, the committee has heard from Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, as well as a number of private forecasters and academic and business economists.

Today the committee continues its hearings in conjunction with the 1989 Economic Report of the President. The focus of today's hearing is the economic outlook and the economic policies of the Bush administration. The committee is very pleased to welcome Mr. Boskin before us this morning and we will turn now to Mr. Boskin for his testimony after a short statement from Congressman Upton.

OPENING STATEMENT OF REPRESENTATIVE UPTON

Representative UPTON. Thank you, Mr. Chairman, for the opportunity to make some brief opening remarks. I very much appreciate the committee's efforts to review various opinions on short- and long-term economic outlooks.

I am particularly interested in the views of today's witness, Mr. Boskin, as a representative of the new administration. I want to welcome Mr. Boskin in his first appearance in his new capacity before this committee and I look forward to working closely with you and the CEA staff as we share the difficult task of examining our complex and dynamic economy.

The Reagan administration released its last economic forecast in its January 1989 budget proposal. My understanding is that the Bush administration will submit revisions to that forecast in the months ahead, but at the present time it is working with the previous assumptions.

Some people have characterized these assumptions as overly optimistic, if not downright fraudulent. Well, a review of the historical record shows that the administration's economic forecasts compare very well with the forecasts from CBO and with other private forecasters.

In fact, over the last 4 years, the administration has actually projected real GNP and the unemployment rate better than the Congressional Budget Office and the so-called "Blue Chip forecast." I hope that all members of this committee will acknowledge the imperfect science of economic forecasting no matter who undertakes it.

The administration's forecasts may well be wrong, and the actual economic indicators for the 1989 fiscal year differ from the administration's figures. However, the record shows that the administration is at least as credible as any other forecaster, public or private.

And, with that, I defer back to the chairman.

Representative OBEY. Thank you.

Mr. Boskin, would you care to proceed?

STATEMENT OF HON. MICHAEL J. BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. BOSKIN. Thank you for your gracious opening comments, both Congressman Obey and Congressman Upton. And I certainly understand Chairman Hamilton's other pressing responsibilities. I've had a long and fruitful interaction with Congressman Hamilton back when I was a private citizen. As a professor at Stanford, he often solicited my advice and I am a great admirer of Chairman Hamilton.

Congressman Obey and other distinguished members of the committee, it is a pleasure to appear before you today to examine the economic outlook in President Bush's economic program. This is my first appearance before the Joint Economic Committee which is, as you indicated, sort of the twin of the Council of Economic Advisers, both being generated and produced and inaugurated and born from the Employment Act of 1946.

I have, of course, testified on numerous other occasions as a private citizen. I have also been a consultant to the Joint Economic Committee whose work I have found over the years to be extremely valuable to improving the understanding of the short and especially longer term trends in our economy.

Among my many responsibilities as Chairman of the Council of Economic Advisers is to prepare for the use of the Joint Economic Committee and for the Joint Economic Committee's dispersal to the rest of the Congress Economic Indicators monthly, a compilation of the statistics and information that we compile in various government and other agencies for your use on monitoring the economy's performance.

What I would like to do this morning, per your request, is to summarize the economic outlook as we see it, the basic thrust of President Bush's economic policies, and then I will be happy to answer any questions of interest to the committee.

I am cautiously optimistic about the economic outlook. There are many people who stress that we are very far along in economic expansion and therefore suggest that it is about to die. There is no economic law mandating that economic expansions die of old age. A simple way to think about that, sir, is that this economic expansion did not die when it reached the age of the second-longest expansion, thereby becoming the longest, and it has continued. There are many examples in the history of other countries where expansions have continued for far longer than ours.

With continued adjustments, I don't want to downplay the possibility of a downturn at some time in the future, but with continued adjustments in the economy, sensible economic policy, and no severe external shocks, the current U.S. expansion can continue for some time to come. Indeed, the current expansion does not currently exhibit the problems that are usually associated with impending contractions such as excessive inventory accumulation.

The U.S. economy has begun to make adjustments to some of its imbalances. Domestic demand growth has slowed. For many years domestic demand grew much faster than domestic production, the difference being made up by net imports.

Over the four quarters of 1988, real GNP grew at 2.7 percent—that includes the effects of the drought, a little over 3 percent excluding those effects—while gross domestic purchases grew at a slower 2 percent rate. As a result, the trade deficit as measured by real net exports in goods and services declined by over $25 billion.

Equally important was the increase in productive investment, with real investment, real nonresidential fixed investment growing at a solid 5½ percent annual rate, somewhat slower than the fairly frenetic pace of 1987. Increases in investment are important because of their effects in raising productivity and real GNP.

Further improvement in the trade and current account deficits will require a reduction in the Federal budget deficit and would, of course, be aided further by an increase in our very low personal saving rate. Let me emphasize that reductions in the Federal Government budget deficit should not come at the expense of productive government investment or actions which lower private saving, because that will merely transfer our low national saving rate problem further from low private saving to more government borrowing.

There are those who are concerned that the real risk we confront is not recession but inflation. That was made more poignant by the release of the Consumer Price Index number for January showing a six-tenths percent increase.

We certainly are at a point in the expansion where an acceleration of inflation is a greater risk than it was earlier. The risk is real and we certainly do not want to allow inflation to accelerate. It would be terrible if inflation drifted up to the levels we saw in the late 1970's. Inflation of that magnitude is not only bad per se, but it is very painful to reduce, as we saw in the recession of 1981-82. Such high and variable inflation has very severe costs and must be avoided.

But even relatively stable inflation in the 4½ percent range, as we've experienced lately, also has substantial costs, although obviously lower than those of the much higher and fluctuating inflation. We should all agree that our long-term goal must be lower inflation, indeed price stability.

In my own view, the current economic data do not yet definitively suggest a permanent acceleration of inflation. There is some ambiguity in the data and it will take some time until we can ferret out whether the January increases are a temporary blip or a signal of more permanent increases.

For example, in the fourth quarter of 1988, inflation as measured by the broadest measure we have—the fixed weight GNP deflator—fell from 5.3 percent to 4.0 percent. As measured by the Consumer Price Index, it fell from 4.7 to 4.3 percent between the third and fourth quarters of 1988.

Producer prices did show a sharp 1 percent increase in January, largely due to oil prices. And as this testimony was prepared before I had the Consumer Price Index data last night, my testimony reveals a statement made several days ago that these will probably also be reflected in consumer prices over the next couple of months.

The employment cost index has been rising more rapidly in the last several quarters. That index reflects both wage and fringe benefit costs. And the Federal Reserve has been attempting to make certain inflation does not accelerate on the wage cost side.

I and everyone in the administration will continue to monitor these data carefully. I do not yet see a serious increase in the underlying inflation rate, but we need to monitor these data carefully to make sure we can tell whether these recent signals are a temporary uptick or something more permanent.

In either case, we will not tolerate an increase in inflation, and the best thing we can do to reduce pressure on inflation and on interest rates is to move to a deficit reduction agreement, a substantial deficit reduction agreement, a credible deficit reduction agreement, promptly.

In the long run, over a span of time as opposed to over a shorter period, inflation is largely a monetary phenomenon. And I support the Federal Reserve's desire to bring inflation down.

As you know, Mr. Chairman, Mr. Chairman-designate, or Mr. Sitting Chairman—what should we call you, Congressman Obey?

Representative **Obey**. Whatever you call me, it will be nicer than what a lot of people have called me, so don't worry about it.

Mr. **Boskin**. Well, it's my pleasure, sir.

And as Congressman Upton indicated, the Bush administration has not made a new forecast. We will produce a full forecast no later than the midsession budget review which is to be released to the public no later than July 15. In the interim, the administration is monitoring events and we have modified the Reagan administration forecast in the preparation of the Bush administration budget proposals to reflect changes in the economy that occurred between the time the Reagan administration prepared its forecast in November 1988, to be released in the January 1989 budget.

Since that time, prior to this morning's CPI number, the inflation and unemployment projections have been quite accurate, but adjustments were required in both the interest rate and GNP levels. In recent months, as we all know, interest rates, especially short-term interest rates, have risen substantially. Actual interest rates for the first 4 months of the fiscal year have been substituted for those forecast in November, and rather than just assuming we immediately get back to those forecast, we have a more gradual path where we meet the Reagan forecast out in the second quarter of fiscal year 1990.

The result of this change in economic assumptions is to raise short-term rates in fiscal year 1989 by 1 percentage point, from 6.7 percent, the level they were at in 1986 and early 1987, to 7.7 percent. Long-term rates for fiscal year 1989 were raised by three-tenths of a percentage point, from 8.5 to 8.8 percent.

The last quarter of 1988, which was the first quarter of fiscal year 1989, showed nominal GNP growth more rapid than had been projected. Because estimates of GNP, as you know, are often revised several times before they are final—more often revised upward, I might add—the level of nominal GNP for the first quarter of fiscal year 1989 was raised only one-half of the difference between this preliminary or so-called advance GNP estimate and the November projection. That is, we didn't take the full increase to accommodate what had happened. We only took half of it to be conservative about where GNP might wind up.

Because higher nominal GNP raises receipts, while higher interest rates raise expenditures, the net effect of these changes and assumptions on the projected deficit were rather small, and I've mentioned them in my testimony. I assume my prepared statement will become part of the record.

There has been much debate over the reasonableness of the Reagan forecast, and I would like to address that briefly and appreciate Congressman Upton's calling to our attention the recent history of forecast accuracy in general and of the administration relative to the CBO and private forecasters in particular.

The first point that is essential to make is that administration projections differ from economic forecasts. This is not just a semantic issue. They are projections based on the assumption that the President's budget proposals will be promptly enacted. This difference is critical. Private forecasters do not make this assumption.

I, as well as most economists, believe that if a major budget deficit agreement is reached, interest rates will fall. Chairman Greenspan has said virtually the same thing. If a credible deficit reduction plan is not adopted and adopted soon, it is far less likely that interest rates will fall and the Fed will have precious little elbow room in implementing a monetary policy designed to achieve steady growth and low inflation.

Second, there is some confusion over the forecasts both of the administration and of others for 1989 because of the peculiarity of the drought that we had in 1988. The drought caused fourth-quarter GNP to come in at 2.0 percent, unadjusted for the drought; 3.1 percent excluding the effect of the drought.

The 3.5 percent increase in GNP the Reagan administration forecast included the normal rebound from the drought. They were assured by the chief meteorologist of the Department of Agriculture that another serious drought is unlikely this year.

Excluding the drought rebound, the forecast is for a modest 2.8 percent growth, slower than the drought-adjusted pace of growth in 1988. So the call, ignoring the drought or excluding the drought, is for a slight slowdown.

Third, I think too much has probably been made of the differences in long-range forecasts made by the Reagan adminstration and what the Federal Reserve has indicated it considers to be the approximate range of long-term sustainable growth. Chairman Greenspan has usually stated 2½ to 3 percent as the plausible range, and the Reagan administration's long-term forecast, which we have adopted for the time being, has been about 3.2 percent over the long term.

Let me mention that differences of a quarter of a percentage point or so on the long-term growth forecast are well within the range of plausible scientific forecast error and well within the plausible range, the range considered plausible by people forecasting productivity growth.

Chairman Greenspan himself has said that he considers these differences to be minor. I think he also used the phrase "minuscule" at one time, and that people were making a mountain out of a molehill or something smaller.

Monetary growth consistent with the Fed's long-term goal is also reasonably consistent with real growth in the range of 3 percent or perhaps even slightly higher. While 3.2 percent is toward the optimistic end of the spectrum—and remember that the administration forecast or projection assumes a deficit reduction plan and therefore a concomitant fall in interest rates—it is instructive to realize that GNP growth has averaged 3.3 percent over the past 40 years, a period including eight recessions, a period including major changes in productivity growth from very rapid in the 1950's and 1960's, to abysmal in the 1970's, to a partial rebound in the 1980's, including about 1.9 percent, which is included as the underpinning of the Reagan administration long-term forecast since this recovery began.

We have also seen major changes in the growth rate of the labor force from modest in the 1950's and 1960's, to quite rapid in the 1970's with the baby-boom generation, and major changes in the composition of the labor force and so on.

In any event, I think that we are talking about differences of opinion that are rather modest by the spectrum of economic forecasts on the one hand and by some well-documented historical cases of disagreement about such forecasts.

Let me also repeat that we will produce a first full set of projections and assumptions no later than the midsession review. Those projections, I can assure the members of this committee, will incorporate not only the updated information we have on the actual performance of the economy between now and then, but the most careful, thorough analysis of likely trends of real growth, both productivity and labor force, inflation, unemployment and interest rates that I and my colleagues at the Council of Economic Advisers, working closely with our colleagues at Treasury and OMB, through what is called the "troika," can possibly develop.

Let me also indicate, while this is not the Budget Committee, let me also indicate that we believed it was important to present the Bush administration budget proposals quickly, and have done so in much greater detail at this early stage of an administration than any postwar change of administrations.

To make a completely thorough new forecast or projection, and then to re-estimate the costs of over 1,000 programs in all agencies of the Government, as well as changes in receipts, would have taken many more weeks. To do so would have delayed presentation of the administration's budget proposals perhaps almost to the eve of congressional budget resolution deadlines.

That would have been much more unreasonable than opting to adopt, for the time being, most of the Reagan administration's projections.

Congressman Upton has correctly indicated what history reveals to be the imperfect science of forecasting. Economic projections are necessary ingredients to making economic policy, but we should understand that they are subject to a certain amount of error.

Forecasting nominal GNP a year out has been subject in the 1980's to errors of about 2½ percentage points by the Blue Chip consensus, by the administration, and by the CBO, and similar types of forecast errors relative to the levels of the various variables would be found in other measures of economic activity.

Indeed, in several recent years, the administration has underpredicted real growth. For the last several years, it has more often underpredicted it than overpredicted it, as has the Congressional Budget Office and private forecasters.

That doesn't suggest that we are underpredicting growth now. I am just indicating that there is some degree of uncertainty in these numbers, and when the numbers come out to the second or, in some cases, the third decimal point, you should understand that there is some range of forecast error that one has to take into account.

With that in mind about projections, let me turn to the administration's economic policies. The administration's primary goal is to promote further growth, extend the current record-breaking peacetime expansion, while avoiding an acceleration of inflation. We believe this has four major components.

It will first of all require reducing the Federal budget deficit substantially, steadily, and predictably. The administration is ready to enter negotiations with the Congress to achieve that end.

Second, it will require continuing and strengthening free and fair world trade through negotiations, for example, in the Uruguay round of the GATT. While we must not allow unfair trade practices to continue, we must also avoid the temptation to fall into a trade war, for that is the surest way to throw our and the world economy into a recession.

Third, it will require the U.S. economy to maintain its flexibility and dynamism, and this will necessitate avoiding unnecessary regulation.

Fourth and finally, and importantly, it will require a monetary policy which predictably controls inflation. Reducing the Federal budget deficit is the surest way to raise the current low rate of national saving in the United States, reduce real interest rates, and thereby provide for continued expansion in business investment, housing investment, and promote growth. And that is the surest way to raise productivity, U.S. competitiveness and standards of living.

There is additional material in my prepared statement relating to saving and various other policy proposals, including the President's tax proposals, but I think that since that is in the testimony I'd rather take time now to throw it open for questions. I would be happy to elaborate on any of those issues, but I think this gives you a flavor of the administration's overall economic policy, the administration's view of where the economy is headed, and the fact that we are carefully monitoring the situation and will be making a new forecast no later than the midsession review.

Thank you, Congressman Obey.

[The prepared statement of Mr. Boskin follows:]

PREPARED STATEMENT OF HON. MICHAEL J. BOSKIN

Chairman Hamilton and other distinguished members of the Committee, it is a pleasure to appear before you today to examine the economic outlook and President Bush's economic program. I will briefly summarize the economic outlook, the basic thrust of the President's economic policies, and then I will be happy to answer any questions of interest to the Committee.

Economic Outlook. - I am cautiously optimistic about the economic outlook. There is no economic law mandating that economic expansions die of old age. They are not like a car that runs out of gas when the tank is empty. Japan, for example, although it has quite a different culture and markets than the United States, has had expansions lasting 20 years and

14 years in the postwar period. With continued adjustments in our economy, sensible economic policy, and no severe external shocks, the current U.S. expansion can continue for some time. Indeed, the expansion currently does not exhibit the problems usually associated with impending contractions, such as excessive inventory accumulation.

The U.S. economy is beginning to make adjustments to some of its imbalances. Domestic demand growth has slowed. This is important because for many years domestic demand grew much faster than domestic production, a large increase in net imports making up the difference. Over the four quarters of 1988, real GNP grew at a 2.7 percent annual rate, while gross domestic purchases grew at a slower 2.0 percent annual rate. As a result the trade deficit, as measured by real net exports in goods _and_ services, declined by $25.3 billion. Equally important was the increase in productive investment, with _real_ nonresidential fixed investment growing at a solid 5.5 percent annual rate, albeit somewhat more slowly than in 1987. Increases in investment are important because of their effect in raising productivity and real GNP.

In addition to the improvement in foreign demand and other factors that have helped to produce these adjustments, further improvement in the trade and current account deficits will require a reduction in the Federal budget deficit (and would be aided by a further increase in the very low personal saving rate). This reduction in the Federal deficit should take the form of slower growth in government consumption. Reductions in productive government investment or actions which lower private saving will reduce rather than raise our future standard of living.

There are those who are concerned that the real risk we confront is not recession, but inflation. We are now at a point in the expansion where an acceleration of inflation is a greater risk than it was earlier. This risk is real and we certainly do not want inflation to drift up into the seven, nine, and finally double-digit rates we saw in the late 1970s. Inflation of that magnitude is not only bad per se, but it is very painful to reduce. We do not want to go through an episode such as the 1981-82 recession again.

High and variable inflation, such as we experienced in the 1970s, does great harm to the economy and must be prevented. Relatively steady inflation in the 4-1/2 percent range also has costs, although far lower than the costs of the late 1970s' inflation. Therefore we are all agreed that our long-term goal should be price stability.

However, the current economic data do not yet suggest a permanent acceleration of inflation. In the fourth quarter of 1988, inflation by the broadest measure, the fixed weight GNP price index, fell from 5.3 to 4.0 percent. Inflation as measured by the Consumer Price Index likewise fell from 4.7 to 4.3 percent. Producer prices did show a sharp 1.0 percent increase in January, but that was largely due to increases in oil prices. The effect of higher oil prices will probably also be reflected in the Consumer Price Index over the next couple of months. The employment cost index has been rising more rapidly in the last several quarters, and apparently the Federal Reserve has been attempting to make certain inflation does not accelerate on the wage cost side. I will continue to monitor these data carefully, but I do not yet see a serious increase in the underlying inflation rate. In the long-run, inflation is largely a monetary phenomenon, and I support the Federal Reserve's desire to bring inflation down.

Economic Projections. - As you know Mr. Chairman, the Bush Administration has not made a new forecast. We will produce a full forecast no later than the mid-session budget review, which is to be released to the public no later than July 15. In the interim, the Administration has modified the Reagan Administration forecast to reflect changes in the economy that have occurred since the Reagan Administration forecast was prepared in November of 1988. The inflation and unemployment projections have been fairly accurate, but adjustments were required in the interest rate and GNP levels.

In recent months interest rates, especially short-term interest rates, have risen and actual interest rates for the first 4 months of FY'89 have been substituted for those forecast in November. Interest rates are assumed to come down gradually to the projected levels by the second quarter of FY'90. The result of this change in economic assumptions is to raise short-term rates for FY'89 by 1.0 percentage point, from 6.7 to 7.7 percent. Long-term rates for FY'89 are raised by 0.3 percentage point, from 8.5 to 8.8 percent.

In the last quarter of 1988 -- the first quarter of FY'89 -- nominal GNP rose faster than projected. Because estimates of GNP are revised several times before they are final, the level of nominal GNP for the first quarter of FY'89 was only raised by one-half the difference between the advance GNP estimate and the November projection.

Because higher nominal GNP raises receipts while higher interest rates raise expenditures, the net effect of these changes in economic assumptions on the projected deficit were rather small. The projected deficit for FY'89 was raised by $0.4 billion, and for FY'90 by $0.8 billion. The changes lower the projected deficits for subsequent years, by $0.4 billion in FY'91, $1.0 billion in FY'92, and $1.3 billion in FY'93. Except for these changes in the level of interest rates and nominal GNP, projections for the future have not been changed.

There has been much debate over the reasonableness of the Reagan forecast, which I would like to address briefly. First, I would like to point out that Administration projections differ from economic forecasts. They are projections based on the assumption that the President's budget will be promptly enacted. This difference is critical. For example, I, as well as most economists, believe that if a major budget deficit agreement is reached, interest rates will likely fall. Chairman Greenspan has stated a similar view. If a credible deficit reduction plan is not adopted, and adopted soon, it is far less likely that interest rates will fall, and the FED will have precious little elbow room in implementing a monetary policy designed to achieve steady growth and low inflation.

Second, there is much confusion over the forecast for 1989. Fourth-quarter over fourth-quarter growth in real GNP was projected at 3.5 percent. Most of this increase in real GNP growth over the 2.7 percent during 1988 is simply the rebound from the abnormally low levels of real GNP caused by the drought. (According to the chief meteorologist at the Department of Agriculture, another serious drought is unlikely this year.) Excluding the drought rebound, the forecast is for moderate 2.8 percent growth, slower than the drought-adjusted pace of growth in 1988.

Third, I think too much has probably been made of the differences in the long-range forecasts made by the Reagan Administration and what the Federal Reserve considers sustainable growth. The long-term forecast of 3.2 percent real GNP growth is only slightly above the 2-1/2 to 3 percent range recently cited by Chairman Greenspan. Monetary growth consistent with the FED's long-term goal is also reasonably consistent with real GNP growth in the range of 3 percent or slightly higher.

While 3.2 percent average real growth is toward the optimistic end of the spectrum of forecasts, it is instructive to realize that real GNP growth has averaged 3.3 percent over the past 40 years, a period including eight recessions.

As stated above, we will produce a first, full set of economic projections and assumptions no later than the

Mid-Session Review. Those projections will incorporate both the updated information on the actual performance of the economy between now and then and the most careful, thorough analysis of likely future trends of real growth (productivity and labor force), inflation, unemployment and interest rates that I and my colleagues at CEA, working closely with our colleagues at Treasury and OMB through what is called the Troika, can develop.

Also, let me indicate that to make a careful thorough new forecast or projection and to re-estimate the cost of over one thousand programs in all agencies of the government, as well as changes in receipts, would have taken many more weeks. To do so would have delayed presentation of the Administration's budget proposals perhaps to the eve of Congressional budget resolution deadlines. That would have been much more unreasonable than opting to adopt, for the time being, most of the Reagan Administration's projections.

Economic Policies. - The Administration's primary economic policy goal is to promote further growth and extend the current record-breaking, peacetime expansion while avoiding an acceleration of inflation. First, this will require reducing the Federal budget deficit substantially, steadily, and predictably. The Administration is ready to enter negotiations with the Congress to achieve that end.

Second, it will require continuing and strengthening free and fair world trade through negotiations in the Uruguay round of the GATT. While we must not allow unfair trade practices to continue, we must also avoid the temptation to fall into a trade war. That is the surest way to throw our, and the world, economy into a recession.

Third, it will require the U.S. economy to maintain its flexibility and dynamism and this will necessitate avoiding unnecessary regulation.

Fourth and finally, it will require a monetary policy which predictably controls inflation.

Reducing the Federal budget deficit is the surest way to raise the current low rate of saving in the United States, reduce real interest rates and thereby expand business and housing investment, and promote growth. Increased investment raises productivity, improves U.S. competitiveness, and raises standards of living.

Household saving has been particularly low in recent years. The reasons for this decline are many, and partitioning blame among the potential causes is difficult. Part of the reason may have been the rapid rise in the net worth of households due to the rise in the stock market during the expansion. Household net worth has risen from $10.1 to $15.1 trillion during this expansion. (The October 1987 stock market fall seems to have adjusted saving behavior somewhat and the personal saving rate out of current income in 1988 rose roughly one percentage point over the 1987 rate). Another reason may have been that the baby boom generation was near the peak of its consumption years. Tax laws may also have had an effect. However, without a confidently precise estimate of the causes of changes in personal saving it is difficult to develop policies to change personal saving behavior. And we must be especially careful not to develop policies which are designed to raise private saving but do so at the expense of public borrowing, thereby just transferring an extra portion of the low national saving rate from the private to the public sector.

Reducing the Federal deficit therefore is the most effective way to raise the national saving rate. Indeed, the Gramm-Rudman-Hollings law targets a balanced budget by FY 93. It is economically desirable not only to meet these targets, but to run a unified budget surplus on average thereafter. The deficit must be reduced in a way that does not reduce private saving or reduce productive government investment. Reducing government dissaving should come through slowing the growth of government consumption.

While an inflow of foreign investment funds has prevented the U.S. investment rate from falling despite the large budget deficits, the share of investment in GNP in the United States is lower than that of most of our major competitors.

High Federal deficits and borrowing also raise interest rates. Interest payments now account for 3 percent of GNP and 14 percent of the Federal budget.

In addition to these economic factors, there is a moral, or ethical dimension as well: we should not be leaving to future generations a larger public debt burden (relative to their income) unless we also leave them more public and/or private assets.

The President's policies include a number of other initiatives to raise investment and productivity. Among these are proposals to encourage long-term investment as well as others to encourage and expand our research efforts.

Prominent among the policies to encourage long-term investment is the President's proposal to restore the capital gains tax differential.

The Tax Reform Act of 1986 was an historic achievement, but one of the disappointments accompanying it was the removal of the differential treatment of capital gains. High tax rates on capital gains reduce the returns to saving, investment, risk taking, and entrepreneurial effort. They also lock in inefficient investments -- preventing capital from moving to higher productivity uses.

A lower capital gains tax rate will reduce the taxes paid on purely inflationary gains and raise investment incentives by increasing real after rates of return. A lower capital gains rate will help to offset the current tax bias against corporate equity. A lower capital gains tax will also improve the U.S. competitive position since most of our major trading partners tax capital gains lightly, if at all.

The Administration's proposals have been structured to assure maximum responsiveness by investors. Not all assets will be eligible for the preferential rate. The proposal limits the lower rate to certain nondepreciable assets, particularly securities, where responsiveness of realizations to tax rate reductions is strongest. In making estimates of the revenue gain, the Treasury has considered possible revenue losses that would result as some ordinary income is converted to capital gains through such techniques as payment in stock options instead of wages. A phased in 3-year holding period has also been proposed to encourage long-term investment.

In addition to the capital gains tax proposal to encourage long-term investment, the President has proposed a number of initiatives to improve the United States position in science and technology. These include increasing investment in basic research, making the R&E tax credit permanent, and investing in education.

In summary, I believe the President's economic proposals are not only sound in the short term, but by seeking to refocus on longer term investment, they provide a framework for enhanced long-term growth. Working with the Congress we can together encourage further economic growth. We have an opportunity, by reducing government borrowing, to increase national saving, investment, and productivity, which is the key to continued increases in the U.S. standard of living.

Mr. Chairman, I would now be happy to answer any questions you or the members of the Committee may have.

Representative OBEY. Thank you very much.

I understand Congressman Scheuer has to get to another hearing, so what I intend to do is to yield first to Congressman Scheuer for his questions, then to Congressman Upton for his, and then I will proceed with mine.

Representative SCHEUER. Mr. Chairman, I very much appreciate your courtesy in recognizing me out of turn. That's not often done and I am very grateful.

Representative OBEY. You're never out of turn, Jim.

Representative SCHEUER. I will ask really one question of Mr. Boskin. I welcome you here and I look forward to many more appearances of yours at this great committee.

Mr. BOSKIN. Thank you, sir.

Representative SCHEUER. I'd like to talk about the whole question of Third World debt. There is a centenary meeting of the Interparliamentary Union in London next September, and one of the major items that they are taking up is the question of Third World debt and how do we manage it.

And there has been, as you know, much discussion of debt for nature swaps. In other words, helping Third World countries in a variety of ways to manage and cope with their Third World debt in return for their agreeing to adhere to higher standards of environmental behavior in general, like saving their tropical rain forests, saving in general their biological diversity.

According to the February 6 issue of the Wall Street Journal, the G-7 Finance Ministers who met last week in Washington have concluded that the Baker plan, and I quote, "has run out of steam and must be replaced." And I think that is more or less a consensus. Perhaps you can comment on that.

The question was raised by the 1989 Economic Report of the President whether a longrun solution to the debt problem must be directed at regenerating investment opportunities within these countries. Short-term solutions must either include reschedulings or other types of negotiated adjustments. Now, the question is how?

We have had witnesses before the JEC, appearing before our committee, Mr. Boskin, actually on February 9, who testified that Citicorp and a few other large commercial banks are harming U.S. foreign policy particularly in Latin America by refusing to deal with small debtor countries like Bolivia and Ecuador because they don't want to set any precedents for dealing with large debtor countries like Mexico and Brazil.

To quote from Prof. Jeffrey Sachs of Harvard:

> "We cannot allow a few commercial banks to be doing such grave damage to our foreign policy interests in this region. Citicorp, as chairman of the steering committee of the major debtor countries, has absolutely locked up this process. It is untenable to have privatization of American foreign policy in this region by a few large banks. It is extraordinarily important," said Professor Sachs, "that we renationalize American foreign policy and put it back in the State Department where it belongs and out of the private banks steering committees. That's the only way we're going to preserve democracies in Latin America, and the time is really now for us to move."

Would you care to comment on this whole question: the effect of the bank steering committees on our foreign policy in Latin America, the possibility of banks engaging in the kind of debt for nature swaps that seem to be very much in our national interest as well as our global interest, and whether it really makes sense for U.S. policies in Latin America to be based on the desire of a few banks to shore up the book value, if not the actual asset value, which has virtually disappeared into thin air, as a way of covering over the horrendously bad judgment that they showed in getting into these loans in the first place.

What do you propose? What new initiatives are you proposing now in the arena of Third World debt management, the role that the enlightened countries of the industrialized West can play. How do we moderate the privatization of foreign policymaking, as Professor Sachs described it? What kind of initiative are you going to show in this area?

Mr. **Boskin**. Well Congressman Scheuer, let me first indicate that the administration is in the process of developing a new Third World debt plan that will build on the Baker plan. Treasury is going to be releasing that soon.

I may not be quite accurate in this; I think that they were originally going to produce something yesterday, but it has been delayed for some time. So I think we can look forward to receiving that soon from the Treasury Department.

Representative **Scheuer**. Will it include the concept of debt for nature swaps?

Mr. **Boskin**. Let me come back to my own views on these things. Let me say that I do not believe it is my place at this hearing to present what may be some of the components of the Treasury's plan in this regard. Treasury will present that soon, when the plan is finalized and is to be announced. And I don't mean to be evasive, sir. I just think it is inappropriate for me to be doing that in lieu of the Secretary of the Treasury, who is the appropriate person to be doing it.

Let me also say you made some comments about foreign policy that I think are more likely to be in the province of Secretary Baker than in the province of the Chairman of the Council of Economic Advisers, although I do respect your right to have your opinions on these matters, and I take them under consideration.

Let me say with respect to your concern about some of the environmental problems in the Third World, that the President has called for a high-level international conference to deal with problems of desertification, of protecting the integrity of the marine environment, of dealing with problems of tropical deforestation and so on.

He has said that he wants to go beyond the Montreal protocol on chlorofluorocarbons. He has made a variety of other environmental issues in his presentation of his budget proposals. He is very much concerned about these environmental issues. There is a large increase in budget funding proposed for Earth sciences, for example, for climate control studies. The United States chairs the Intergovernmental Policy Committee Working Group on Strategic Responses. Great Britain chairs the one on science. So there is movement on these fronts with respect to the environment.

With respect to Third World debt problems, it has been the previous administration's proposals, and the heart of the Baker plan to deal with these on a case-by-case basis rather than dealing with them as a group, and to encourage where possible private relations and private agreements between debtor countries and creditors. And I think that that is a wise idea.

Beyond that, sir, if I appear to be evasive, I don't mean to be. I think that I should go no further, and allow the Treasury Secretary to announce the policy when it is finalized and ready for presentation. I will make certain that you receive a copy of that immediately.

Representative SCHEUER. I would appreciate that, as well as the Treasury report when it comes in.

I appreciate your candor. Nobody in the world could possibly think you're being evasive. You are being very forthright, and I appreciate it.

You ticked off some of the things that the President has said he is going to do on the environment. I am guardedly optimistic about what we're going to accomplish on the environment. And one signal that he sent that was very clear was the superb appointment of Bill Riley as head of the EPA. I don't think he would have appointed Bill Riley if he intended to do nothing. I think he intends to do a lot, and we look forward with great hope to this new administration's posture on our own environmental problems in this country and also globally.

I might say I am particularly encouraged by the signal that I got from Bill Riley. I've never met the gentleman, but he did send me a Christmas card. I suppose he sent it to other Members of Congress. And the Christmas card was a picture of him and his wife in the jungle someplace, with a great big python curled around his neck and around his wife's neck and shoulder.

Representative UPTON. That was Congress.

Representative OBEY. That was the budget deficit.

Senator SYMMS. You know, I met him, but I don't think he sent me a card.

Representative SCHEUER. It could be that he was trying to tell us that if he can cope with the snakes in the jungle, he can cope just as well with the snakes in Washington. That seems a reasonable interpretation.

I thank the chairman very, very much for his courtesy. I'm very grateful. And I thank you for your answers.

Representative OBEY. Congressman Upton.

Representative UPTON. Thank you, Mr. Chairman. Thank you again, Mr. Boskin, for joining us this morning.

I touched in my opening statement, and you referred to it a couple of times in your statement as well, about the track record that the administration has had with regard to forecasting, particularly as compared and contrasted to some of the other leading ones like the Blue Chip and CBO. But let's face it; what really raises everybody's eyebrows, in this case the Reagan administration's forecast, is the interest rate projection.

In listening to some of the comments that have been made by Budget Director Darman, perhaps yourself, I'm not sure, is that even it the Bush budget proposal was enacted along a fairly similar track, Mr. Darman has indicated that, well, all the economists still will say that if the Bush budget is enacted, interest rates will in fact come down.

If it is enacted, do you think that they are going to come down to the same level? I mean Mr. Darman was somewhat evasive from what I saw with regard to the exact level that they would come down.

What are your thoughts? If the Bush budget is in essence enacted, where do you feel interest rates will come down to? Will they be as optimistic as what Reagan proposed, which were off in the first quarter of fiscal year 1989 by a fairly large margin? What do you think?

Mr. Boskin. I think they will come down and they will come down substantially. I think if we go back to—there are two points to remember—if we go back to 1986 and early 1987, you will see that short-term interest rates were in the 6 percent range. So it's not ancient history.

And also if we go back to the period immediately after passage of original Gramm-Rudman-Hollings Balanced Budget Act, interest rates came down substantially. So I think financial markets pay careful attention to this, and if the proposals are passed and are believed credible, and it's believed they will be enforced over time—even better if there is a multiyear dimension to it—then I believe interest rates will come down and come down substantially.

Now, whether they come down all the way to where the Reagan administration forecast for the next year, and then the Reagan administration forecast has them coming down steadily through time, depends heavily on the course of inflation over that period of time. I believe that if eventually we make progress in getting inflation down to the levels forecast by the Reagan administration, which were quite low by 1994, down to 1½ percent inflation, then indeed interest rates will come down approximately to that level, perhaps not quite that far but approximately that level.

I think that is would be prudent to consider the possibility that while we make progress against inflation, that if it is somewhat less than forecast in the Reagan administration forecast, that nominal interest rates will fall less if inflation falls less, and that both inflation and interest rates, while they may fall quite a bit, may fall less than forecast in the Reagan administration. That's difficult to tell in the outyears out there in 1992, 1993, and 1994.

But let me indicate that if, as a hypothetical example in one of those years or in the path, both interest rates and inflation were about 1 percentage point higher than forecast, although substantially lower than today, that would about wash in terms of the budget deficit. The Congressional Budget Office would, by its rules of thumb, say that that would probably raise revenues more than it would raise outlays, and it would reduce the budget deficit. The rules of thumb that the administration has indicated would be about a wash or maybe a cost a trivial amount in terms of the budget deficit.

Representative Upton. In your comments in your statement, you talked a little about personal savings rates and how they were higher in other nations. We've had some hearings already this year, and we've talked about some of the tax treatments that other countries have with regards to savings, particularly the Japanese.

Are you in basic agreement that the savings structure is somewhat responsive to the aftertax rates and would you forecast the administration making some proposals later on this year as we look at that?

Mr. BOSKIN. Well, the administration believes the low personal saving rate is a problem. The President, during the presidential campaign, indicated he wanted to see saving and investment increased and proposals to do that. Some of the proposals work on the investment side, some on the savings side. There would be a small impact on overall saving from the capital gains proposal, for example.

But let me just say that when we look back at the experience we've had, for example, with individual retirement accounts, there are sort of three factors to consider:

How much net new saving was actually generated by the IRA's? And I believe the answer to that, the best statistical studies indicate that about half the funds that flowed into IRA's were net new saving.

And then, of course, there is some tax arbitrage as people transferred funds from existing taxable accounts into tax-deferred accounts.

And then, of course, there is the possibility of losing revenue. If you have something like an individual retirement account which allows people the deduction up front, that will cost the Treasury revenue.

Our major problem is the national saving rate, the sum of the private saving rate, business plus personal, and the government dissaving—Federal, State, and local borrowing. So I think we have to be very judicious about proposing any incentive for saving, for private saving, that we are not absolutely certain will not cost the Treasury any sizable amount of revenue.

So while I personally thought that IRA's were partially successful, to bring them back under the current deficit phenomenon we now face I think would be inadequate because we would be in a situation of losing some revenue up front to try to stimulate private saving. And even though we probably would stimulate some private saving, our national saving would be offset by the extra deficit.

Down the road, once we have the deficit under control and deal with the surest and safest way to raise national saving, which is to reduce the Federal budget deficit with actions that don't harm private saving, down the road when we're in that situation, then I think we would be wise to reconsider the possibility of structural changes in our tax system such as IRA's to try to provide greater incentive to saving.

We did put some things into the 1986 tax reform that decreased the incentive to borrow. For example, some limits on interest deductibility for consumer credit and lower tax rates also make debt finance less attractive.

Representative UPTON. Your comment with regard to the IRA's, an objection of course being that it in fact would reduce revenues to the Treasury—of course, President Bush has come out in support of lowering the capital gains tax rates.

Wasn't there a study that Treasury did under Jim Baker not too long ago, 2 years or so, that when they looked at lowering the capital gains, that they actually saw that certainly in the short term it was going to be a reduction of revenues to the Treasury, and wouldn't that same argument then face the same type of test with regard to the IRA's that you just made?

Mr. Boskin. My understanding is the following: that the estimates that the Treasury Department has made for this capital gains proposal are entirely consistent in methodology with the previous estimates.

Also, the study that you were referring to contain some flaws which were corrected subsequently in a 1986 study released by the Treasury, authored by Assistant Secretary Darby, and the conclusion was that a reduction in the capital gains tax rate would not lead to a reduction in revenue.

Representative Upton. Do you have a copy of that?

Mr. Boskin. I don't have it with me, but I'll be certain to have one delivered to you today or tomorrow.

Representative Upton. Great. Thank you.

Mr. Boskin. You are quite correct. There was a study that indicated that. Its evaluation and some of the historical time series studies indicated that, but there were some flaws in the methodology that were subsequently corrected and a new study was put out. I believe that's the official Treasury position or at least it was as of Secretary Baker's administration, and I will get you all those studies, Congressman Upton.

Representative Upton. Thank you very much.

Representative Obey. Thank you, Congressman Upton.

Mr. Boskin, for an economist you produce a pretty good political document.

Mr. Boskin. I don't know whether to take that as a compliment or an insult, sir.

Representative Obey. Well, there's nothing wrong with being a politician. I admire the grace with which two things have been accomplished, although I might not necessarily agree with the substance.

It seems to me that if you read your statement and if you couple what you say in that statement with the President's budget document, you have a very interesting thing that's happening here.

What we have here in your statement is that you have indicated for some reasonable reasons that the administration is not going to make a new forecast until sometime in July, which creates interesting problems for the Congress if they proceed down the budget road and then find out that we're dealing with a different set of economic assumptions halfway through the appropriations process. It kind of mucks up the year. So that's one potential black box that we face.

We've been given another one with the President's budget which in essence really isn't a budget. I mean it's sort of like walking into a candy store and saying I want some jelly beans and some jawbreakers and some M&M's but I'm not going to tell you what I'm going to pay for them with—because we have lots of postponed decisions in that budget.

Then what you say in your statement, you defend the administration's economic assumptions, which according to the chart I'm looking at here would indicate that in terms of economic growth, the administration's optimistic assumptions are matched by only 2 of the 50 Blue Chip forecasters for 1989. If you take a look at your assumptions on interest rates, assuming the decline of interest rates, your optimism is matched by only 9 of the 50 Blue Chip predictors.

So the Congress is being given a budget which is based on economic assumptions that may change in July and which contains unspecified, later-to-be-found reductions of $11 billion. And then we are told in your statement, "but by the way, boys and girls, if you don't pass this budget quickly, then we're not going to meet these optimistic assumptions."

It kind of reminds me of the observation made by a Republican who said, "You know, in 1964, they told me if I voted for Goldwater the country would wind up in a war. And I did, and we did."

You've sort of defined yourself into a no-lose position where you are producing a budget based on assumptions about which there is some considerable doubt. Then you're telling us we have to pass that budget immediately, but we haven't been told what that budget is, which makes it difficult to pass it immediately.

And I think you're getting away with it, which is why I say that I admire the political skill with which this budget has been presented, even if I don't admire where that leaves us in terms of being able to really attack our deficit problems. I simply wanted to make that observation in passing.

Let me ask you a question with regard to your assumptions. I was just in my district for a week, had several meetings with pretty thoughtful businessmen. Why do they chuckle when I describe to them the administration's expectations for interest rates over the next 2 years?

Mr. BOSKIN. Sir, not knowing exactly who you spoke to and their own circumstances, I don't really know the answer to that question.

Let me just repeat one or two things. One is that these interest rate forecasts made by the Reagan administration which were modified somewhat by us to reflect reality and a gradual adjustment, and will be revised later on, do assume passage of the President's program or something that is economically similar. It might not be identical to the President's program, but it implies that a credible deficit reduction program, whether the President's or a negotiated one that has similar economic effect, is adopted relatively soon.

If we go on to the end of the year and have not managed to accomplish that, I think we will clearly have a year where interest rates don't fall as projected, as I indicated in my testimony.

So I think that it may be, with all due respect, it may be that some of these people are dubious that there will be a deficit reduction program. I hope that that is wrong.

Representative OBEY. No, because when I described it, I told them to assume that the budget would be in place just as it was last year, on time. The trains are going to run on time, even if what they're carrying is a questionable load. The trains are going to run on time. The Speaker has already made that quite clear.

I told them to assume that we passed the President's budget. What do they think they're going to be paying for T-bills? What do they think long-term interest rates are going to do? And would any of them do business on the basis, of those predictions? And I found lots of raised eyebrows, not many offers.

Mr. **Boskin**. Well, if you have any further documentation of that, I would appreciate it. It would be helpful to me. I take that under advisement and I will certainly use that information. I can just say that the economists I know, including Chairman Greenspan, have said that if a credible deficit reduction program is passed promptly, that interest rates will fall.

Representative **Obey**. At the same time that economic growth is accelerating.

Mr. **Boskin**. Well, the forecast actually, sir, is for economic growth to moderate slightly between 1988 and 1989. As I indicated earlier, it's confounded by the drought effect, but excluding the drought effect it's for economic growth to be slightly less in 1989 and 1988.

Representative **Obey**. I think there's some question about that.

Mr. **Boskin**. May I make one other comment, please, sir?

Representative **Obey**. Sure.

Mr. **Boskin**. You did indicate this conundrum of the Congress having to move in real time and that the first time that we are required by law to produce a full set of projections and forecasts is the midsession review.

There is no desire on the part of the administration to hide indeed most of what——

Representative **Obey**. I'm not suggesting there is. I'm simply laying out the practical problem presented when we are told to pass a budget and we don't know what that budget is and we don't know really what the economic assumptions are that you expect to be facing down the road.

Mr. **Boskin**. We will be, as I indicated, revising them continually and updating our information base as information about the economy, whether GNP continues to come in stronger and interest rates higher and so forth, as we move forward. But I do think that unless something radical changes that we do not anticipate, I would not anticipate large changes from those projections.

But even more important than that, sir, is the fact that whether or not those projections prove to be accurate, a credible deficit reduction program which you might decide to predicate on somewhat different assumptions—a quarter of a percent lower growth or somewhat different interest rates——

Representative **Obey**. With all due respect, sir, the Congress can't do that. You're setting up a scenario that doesn't exist. What people don't seem to appreciate is that the court changed Gramm-Rudman. The Congress no longer has an ability to debate the President on economic assumptions because OMB now defines what those economic assumptions are going to be when they determine whether we're going to run into sequestration in October.

The Congress' arm, the CBO, produces only an advisory opinion, so the Congress has no institutional ability to depart from the administration's economic assumptions, even though we might think they were Alice in Wonderland assumptions because of the change in Gramm-Rudman law. And I think when people understand that, and most people don't, they will understand the dilemma faced by the Congress in dealing with a very spongy budget product.

Mr. **Boskin**. You are quite correct that the law puts in the power of the Office of Management and Budget the forecast about whether or not the Gramm-Rudman target will be hit, and therefore whether or not sequester will be triggered.

The projections are made through a troika process where the Council of Economic Advisers heads the economic projections and those are required by the Employment Act and subsequent amendations to be the basis upon which OMB estimates outlays and Treasury estimates receipts, and there is a three-level troika process that is involved in generating those.

We will start that, obviously, in the spring. It takes some time to go through the technicalities of all that and for our own internal use we will have that certainly earlier, but there's a law that says it must be released to the public no later than July. But you are quite correct that the courts did sever this kind of CBO, OMB and then external arbiter that was in the original law.

Representative **Obey**. The importance of that fact is simply this. We see all kinds of op-ed pieces being written by economists and noneconomists alike, asking what should be done in the budget process, how is the congressional budget process going to work. And the fact is that the congressional budget process, because of the Gramm-Rudman change, has become an absolute prisoner of White House assumptions on economics, because since 1921, as you know the President has always has the obligation to present his budget. And he has 90 percent of the resources in the Federal Government to produce that budget.

If that budget starts the process by either being cloudy in terms of what it recommends, or if it starts the process based on assumptions which are privately held to be not quite on center, then the process is crippled from the beginning, and there is no ability for the Congress to correct the basic problem. We may deal with the marginalities in terms of budget priorities, program versus program, but the Congress itself cannot correct the basic problem if we start out with a set of faulty assumptions. And that's why I think there's so much concern about the fact that your assumptions depart significantly from any other observers.

Mr. **Boskin**. Let me just indicate once again that we made some minor modifications—we adopted for the time being the Reagan administration proposals, we made these modifications in interest rates and the GNP level—that we will be producing a new set of projections, and that if there is a set of negotiations ongoing between the Congress and the administration, I am certain that there will be an exchange of information about the likely evolution of the projections.

I don't think there is any attempt to sort of hide that and pull a July 15 surprise or anything, sir. But I understand where you're coming from and I appreciate the dilemma.

Representative **Obey**. The problem is that the appropriations process has to be done by July 15 and you instruct us to pass a budget quickly when we still have not been given a single budget authority number by the administration. So your warning here that we are not likely to meet your expectations for the economy if we don't pass the budget would be credible—and you used that word repeatedly in your statement—it would be credible if we had been given a budget because, as you know, budgets operate on the basis of budget authority, not outlays. And we have been given no budget authority numbers by the administration.

Mr. Boskin. Let me just indicate, sir, without getting into the details of the exchange of information that's currently ongoing between OMB and the Congress, that it is my understanding that this is the most extensive set of revisions that have been provided at this stage of an administration.

Representative Obey. Only outlays. No budget authority, and budget authority is what drives deficits. It is what drives spending and it is what the appropriation bills are built on.

I mean this is not a partisan question. People must understand that we have not been given one number that constitutes an operational budget in congressional terms by this administration—not one.

Mr. Boskin. It is my understanding that a variety of options has been laid out, that we are anxious to get into negotiations, and will continue to provide additional information.

Representative Obey. You can negotiate with the Budget Committee because the Budget Committee defines outlays. But the Appropriations Committee must have budget authority numbers, or else the only way we can proceed is to either totally ignore the administration's budget or to assume that we will simply produce a sequestration level budget across the board through the appropriations process.

Those are the only two institutional alternatives you leave us, neither one of which are very desirable, but you sort of made our bed for us and we have to lie in it.

Mr. Boskin. Let me back up to a couple of points if I may, sir.

First of all, let me say that in the process of negotiations and the meetings that have occurred, I believe the Appropriations Committee chairmen and ranking members from both Chambers have been included, and it is certainly the intention to include them.

Representative Obey. That's right. And they've been able to sit in a meeting when no questions are answered in terms of the numbers they have to have.

Mr. Boskin. Second, it is my understanding that if and when negotiations are entered into, that among the things that will be quickly, hopefully, negotiated are precisely these numbers.

Let me also say that undoubtedly part of that exchange of information will be on the economic outlook for the purposes you indicated. But let me also indicate two or three other things that I think are not commonly known.

After adjusting for the administration's savings and loan proposals which Secretary Brady is presenting today to another committee, the CBO and OMB deficit projections for fiscal year 1990 are quite similar. Let me also say that while we are often accused of rosy scenarios, and you have indicated that you think these are quite optimistic and they're toward the more optimistic end of the Blue Chip forecasters—only a few have growth as high as ours—or interest rates coming down, although they typically do not condition their forecasts on a deficit agreement being reached, let me say that CBO estimates substantially more revenue at any given level of income than does the Treasury.

And therefore I want to make it clear that as we go back and try to reestimate everything on the basis of changing economic assumptions through time, that we will be trying to cooperate with the CBO to understand what the differences are and why they occur, and try to get that as quickly as possible.

Representative OBEY. My time has long since been up, so I would like to pass the witness to Senator Symms. But let me simply observe that our major problem is not the fact that you haven't presented the economic assumptions. I think there are understandable reasons why you have chosen the path you have chosen on those.

My problem with your statement is you indicate that unless we pass the President's budget quickly, the economy will not perform as you suggest that it is gong to perform, and my point is we can't pass a budget we haven't received and we have not yet received a single budget authority number.

Mr. BOSKIN. I understand that, sir, and with all due respect, my point is that a deficit reduction package which is substantial and credible, whether it is indentical or not, exactly the same as that currently proposed by the President, or one that would be negotiated hopefully soon in a bipartisan manner, would have a substantial sobering effect on financial markets and lead to a reduction in interest rates, as many people have suggested; and that hopefully negotiations could begin soon and get that process going.

Representative OBEY. I hope so, too, but meanwhile it's pretty hard to play a football game if the guy who has the ball doesn't kick off.

Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman.

Mr. Boskin, since it's total spending that really matters in this argument as we really measure the burden of government on the working men and women of this country, maybe later this year, in your first official forecast, you could consider issuing two separate forecasts—one that would assume a deficit reduction package through spending cuts alone, and another that would assume a stalemate in Congress that would drag on until Thanksgiving.

Mr. BOSKIN. Sir, it will certainly require at midsession for us to incorporate all the information on the economy up to then. What happens in financial markets between now and let's say June or July certainly will reflect the financial market's view on whether this scenario you indicated is likely to happen.

Now, I am also a believer in presenting alternative scenarios. Whether those would be the ones that we would likely lay out, rather than ones with alternative economic assumptions, would be questionable.

Senator SYMMS. Chairman Greenspan has said on numerous occasions, both publicly and privately, that if people want to see interest rates reduced, Congress should adopt a budget close to that which the administration has sent over in terms of deficit reduction.

Do you agree with that?

Mr. BOSKIN. I certainly do.

Senator SYMMS. Well, then I want to go back to the economic assumptions of the administration in recent years. I think Congressman Upton made that point earlier.

If you compare the assumptions of the administration in recent years, they have been slightly optimistic, wouldn't you agree?

Mr. BOSKIN. I think if we look at the Reagan administration's projections of real growth, they more often underpredicted growth than overpredicted growth. They were more often too pessimistic about real growth rather than too optimistic. They were usually more optimistic than private forecasters and the CBO on real growth.

Senator SYMMS. Isn't it true, though, that the Blue Chip 52 forecasters, in recent years, have been under the mark in what they have predicted?

Mr. BOSKIN. On real growth, that is correct.

Senator SYMMS. So that brings us to the question: Who is going to be right this year? Of course, we don't know. When I look at the fact that 8 years ago we had less than $600 billion of income or revenues flowing to Treasury, and that now we have $1,073 billion of income flowing to Treasury, I personally think it's disgraceful that Congress can't run the Government on this much money.

I've often said: Thank God we don't get all the Government we pay for, because if we did we'd have the whole private sector shut down. This is not to say that we're short on government regulation. I find it difficult to understand why Congress is unable to operate the Government with current tax income. We are always talking about tax increases. What is your feeling on government spending that is out of control? Should we continue to increase taxes?

Mr. BOSKIN. Well, it would depend on what else was going on. I certainly believe that a rise in Government spending diverts resources from the private sector and can be harmful at times. It would also depend on that those extra funds were used for. If it were legitimate, productive investment, that would have to be considered.

I certainly believe in analyzing the current set of outlays and projections, that there is great merit in adopting the approach that the administration has adopted, which is to signal some priorities for increases in spending in some areas, but try to limit the growth in many others and to try to change the tone from what we will spend if we project out into the future someone's notion of what likely expenditures may be even if inflation for some components is many times the overall inflation rate, versus trying to—as you put it—live within your means, try to allocate the extra revenue that the administration and the CBO expect to be coming in to high-priority uses.

We believe the highest priority use, to start with, is to reduce the budget deficit. So there is a conditional agreement with some of your statement.

Senator SYMMS. I appreciate that.

One of the things that does concern me greatly, though, is if the Federal Reserve Board decides we need a tighter monetary policy to the point that monetary policy becomes even more important than fiscal policy. The Budget Committee usually votes to decide which set of economic assumptions they are going to work from, or agrees on it in some fashion.

It seems no matter what we do, we end up with reduced economic activity, reduced revenue to Treasury, and a compounded problem.

Mr. Boskin. Well, it is certainly correct that monetary policy can have a pronounced influence on the economy and it is certainly correct that the Federal Reserve in my view, prudently thus far in trying to prevent an acceleration of inflation, has been nudging up short-term interest rates. It is doing that to keep inflationary expectations under control and therefore to keep long-term interest rates which heavily affect investment in housing and long-term business investment from rising, and therefore to keep those sectors relatively robust.

My own view is that low inflation is necessary for continued economic expansion; that if we let inflation or the genie out of the bottle, that we will have to take more abrupt action.

With respect to your hypothetical case of the Federal Reserve tightening further and further until it's too much, that is certainly a possibility.

Senator Symms. Don't you think that happened in the early 1980's, though?

Mr. Boskin. I think it has happened previously, including in the early 1980's and in previous times. I have a great regard for the Chairman and the members of the Federal Reserve Board and the system, and I believe that they are trying to balance, with modest elbow room at the moment, the possibility of keeping inflation under control while sustaining real growth, and that a deficit reduction package would give them more elbow room and make their task somewhat more manageable.

But I certainly agree that there have been times when they have inadvertently overdone it. I don't think they've done it deliberately.

Senator Symms. I want to say that I am very pleased to see that the administration is now taking a very careful look at where we have lent money with respect to what the environmental impact is going to be in some of the lending we have done through the different international development banks. I think the United States has historically lent money without really getting enough of what I would consider a fair environmental assessment. Maybe we should put the brakes on some of these loans that we've made in different places around the world.

As a matter of fact, last year my bill passed the Environment and Public Works Committee; this legislation would have required the Treasury to have an environmental assessment before Congress would fund IDB's.

Another subject that is of great concern to me, and I'd like to hear your comments on it, is the phenomenon now of private banks in Japan, West Germany, and the United States that make untied loans to the Soviet Union, and who in turn get a preferred interest rate because they are guaranteeing these loans with the credibility of their government. They then take the cash and use it in the Pacific Rim to expand their naval fleet operations. They use it in Vietnam or Cambodia. They use it in Angola. They use the money in Nicaragua to fight the wars of a so-called Marxist-Leninist revolution.

At the same time, if the Japanese, for example, lend money to the Soviets and they expand their operations in the Pacific, then we in turn, in order to meet that threat, have to have a stronger blue water Navy, which costs us money and has a negative impact not only on our budget, because then we have to fund a bigger, stronger, more mobile Navy, but it makes us less competitive with the Japanese who have lent the money and don't provide their own blue water Navy defenses.

Could you comment on this? I know that the administration, in order to do anything about this, has to continue to bring it up with our allies and our trading partners. It's not government-to-government lending, but it has a direct negative impact on the U.S. budget and our ability to deal in the world.

Mr. **Boskin**. Let me first say that the entire set of issues you have raised is a subject of discussion with our allies through the State Department and other venues.

Let me also say that the basic thrust of administration policy is to balance or to deal with the legitimate commercial lending concerns, trying to make sure that that doesn't cause or promote some of the side effects that you mentioned.

I think we've been encouraged with some recent moves in the Soviet Union, but again we're cautious with respect to this. So I don't think we would be very anxious to see lending of any sort which wound up directly producing the results that you have indicated. I think we are evaluating that situation and if we came to that same conclusion we obviously would act on it.

Senator **Symms**. It seems to me that to lend money to the Soviets to have them help expand consumer goods industry, which is desperately needed in the Soviet Union, in order that their people might enjoy some kind of a better life is one thing, but to lend them money untied, where they turn around and use it to create a situation or conflict somewhere else in the world where we have to fund a bigger Defense Department and a larger defense budget in order to meet this threat just doesn't make sense.

I hope that the administration will continue to pursue this issue.

Mr. **Boskin**. I take the point, sir.

Senator **Symms**. Thank you very much. And thank you for being here this morning.

Mr. **Boskin**. Thank you, Senator.

Representative **Obey**. Senator Sarbanes.

Senator **Sarbanes**. Thank you very much, Mr. Chairman.

Mr. Boskin, I want to go off in a different direction here for just a couple moments. First of all, when were you sworn in?

Mr. **Boskin**. I was sworn in the evening of my confirmation by the Senate, by a notary in my office, which would have been Thursday, February 2.

Senator **Sarbanes**. All right.

Now, what has happened with respect to the other two members of the Council? I am concerned—I've expressed this concern before, and here we are now in the latter part of February—that you're the only member of the three-member Council who is in office. What's happening with the other two people?

Mr. **Boskin**. The other two people are in process. They are in the works and we've all seen much written about what is going on with the pace of that. Things are progressing. We all would have liked things to progress more rapidly. But without trying to evaluate exactly what the reasons are or assessing any blame, they continue to progress, and I am hopeful that we will soon have the other two members on board.

Senator SARBANES. Let me make this very clear, because it came up yesterday in the Foreign Relations Committee where they have been moving extremely slow in nominating positions at the State Department.

They said, in effect, "We expect very soon to be able to dump 36 nominations on your desk. We're going to move all these people out of here and send them all up there."

Then, of course, as soon as that happens, then the administration starts asking why won't the Congress approve these nominees forthwith, making a mockery out of the confirmation process.

Now, we acted very expeditiously on your nomination. I don't know how it could have been any quicker, frankly, with the exception of Secretary Baker who got a hearing actually before the nominations were made. You had your hearing. I think you were right up front amongst all the nominees, and then moved through the Senate quickly thereafter.

Mr. BOSKIN. That is correct, sir, and I greatly appreciated it.

Senator SARBANES. And I hope we can do the same with your colleagues. But those nominees ought to be up here, and it ought not to be anticipated that they will be sent to the Senate one day and then approved the next day. There has to be some respect for the confirmation process.

Mr. BOSKIN. I appreciate that. I have a great deal of respect for it, and I have a great deal of respect for the role of the Senate in that regard, and the people that will be appointed will have a great deal of respect for that.

We understand that there will be some careful deliberation and some time necessary and I certainly will make sure that no one from the Council of Economic Advisers does what you appear to be concerned about happening. From the other nominations you're suggesting, it suggests that after taking some substantial length of time on our end, for whatever reason, that anything other than instantaneous confirmation is in any way irresponsible behavior by the Congress. It certainly would not be so. I would expect there to be a careful and thoughtful and full confirmation process and we will, as soon as we are able, we will get those nominations to you and we expect to have a full, careful, considerate confirmation process.

Senator SARBANES. I don't attribute the delay in sending up your colleagues on the Council to you individually. In fact, my sense of it is that you have been trying to get them as well, and I hope this line of questioning this morning will give you some additional ammunition to move them through the administration.

Mr. BOSKIN. I intend to make a phone call as soon as I get back to my office.

Senator SARBANES. Now, the other question I want to pursue is, again, not the subject of this hearing. But we have you here and I'm not sure when I'll have another opportunity to discuss this matter of the Federal statistical base, although I am thinking of asking Chairman Hamilton to allow me to hold some special hearings on it.

The 1988 report last year of this committee had a section on the statistical infrastructure, expressing significant concern about what was happening in those programs. This is an item on which Congressman Obey and I have worked closely together in the past.

It's my own perception, as was stated by Robert Samuelson in the Post some 3 years ago, that:

> Throughout the government there has been a nibbling away at the statistics we collect to show our social and economic condition. To be sure, these are austere times and some information is available from private sources, but mostly these cutbacks are shortsighted and abandon government's legitimate functions. Good political decisions are hardly guaranteed by good information, but they are even less likely with bad information.

At the time, this committee held 2 full days of hearings on the quality of the Nation's economic statistics, and I commend those hearings to you. They are still pertinent, even though held some 3 years ago. I noted then the importance that the Japanese are attaching to their national statistics programs. In fact, they have placed great emphasis on them in the postwar period. They now have a national statistics law. Under it, they hold a month-long celebration every year in honor of statistics.

A couple of years ago, the theme of that month-long celebration was—and I'm now quoting—"Statistics are the beacon for our happy life." While there is some humor to that, I think that there is a real problem.

Congressman Obey and I have tried over the years, with some success through the Appropriations Committees, to get adequate moneys for the various activities.

Have you made clear to the President your own views on the importance of assuring adequate budget resources to the statistical agencies?

Mr. Boskin. Yes, I have. Let me first say that I couldn't agree with you more that over a span of time, not just in the Reagan administration, but over a span of time, I think that the statistical agencies have been operating under some severe resource constraints; that because our economy has changed rather markedly in the last, let's say 20 years, that there are some types of information that it would be very valuable to have that they have been unable to free the resources up to collect and so on.

And while I am not intimately familiar at this point with that, one of my points of references was indeed the hearings that you were referring to earlier, sir. I personally believe that a major effort must be made to improve, update, augment, and append our Federal Government's statistical base on economic statistics.

I have raised this issue with the President. He is aware of it. He supports it. There is a statement in the budget proposals about this. The Council of Economic Advisers is currently studying, in cooperation with the various agencies and the various statistical people in those agencies, the various government statistics. I myself have met personally with the people in the Bureau of Economic Analysis, as well as with Secretary Mosbacher, in dealing with Commerce Department statistics. I've met with Chairman Greenspan about this, and I think there is widespread feeling at the top that we must try to make an effort, at least get one started soon, to try to improve and update these statistics.

So that is something that I hope the Council will be doing. I personally believe that it is my legal responsibility, as I read my obligations under the Employment Act, and providing Economic Indicators to the Joint Economic Committee, et cetera, to make this known and to do what I can to improve those data.

Senator **Sarbanes**. Let me urge you on in that task.

Let me simply make this observation. The President did say in his budget message that he supports a sound balanced program to collect and disseminate comprehensive and accurate statistics. As in other areas, however, when we go beneath the rhetoric to see what the substance is, unfortunately it's not there.

My examination of the budget leads me to the conclusion that if one sets aside the additional moneys necessary for the 1990 decennial census—which are of course quite significant, but occur only once every 10 years—there are in effect no additional resources for statistical purposes in this budget, no increase in resources. I think that is something you need to focus on.

Now, finally, because my time is up, let me just put one final point to you. The Paperwork Reduction Act that was passed in 1980 set forth guidelines with respect to Federal statistical policy. Unfortunately, these guidelines have proved controversial in subsequent years and often, in my view, counterproductive. They have in fact been used to try to diminish the statistical effort on the part of the Federal Government.

That act is scheduled for reauthorization this year. Therefore there will be an opportunity to take a careful look at the guidelines, to revise them to ensure that they strengthen rather than hinder the work of the statistical agencies.

I would hope that you would review the relevant provisions of the Paperwork Reduction Act and play a leading role within the executive branch with respect to changes and improvements to it to facilitate the work of the statistical agencies. I want to put that to you as a responsibility here this morning.

Mr. **Boskin**. I take it, and I appreciate it, and you can be assured that I will, sir. I appreciate your comments.

I think that we have a very large number of very dedicated, hardworking persons in the various statistical agencies who don't get enough credit for the work they do, and who often have ideas and things that they would like to be doing along the lines you suggested to improve our statistics. In some cases this may require some reallocation of resources within the statistical agency or within the broader agency. In other cases it just may take some impetus from the top to say yes, I believe this is a high priority, and I intend to do what I can to elevate this discussion to more prominence and to see what I can do to improve the work of the statistical agencies and the statistical data base that we use.

Senator **Sarbanes**. Let me simply note that often a very modest increase in the resources available to these statistical agencies can have a disproportionately positive effect on their capabilities. These are invariably small. A statistical agency absorbing a 5- or 10-percent cut, year after year, ends up having to deal with a much more severe impact on its activities than does a much larger department or agency where there's more room for absorption of such a cut. And it seems to me that we need to focus on that.

There is strong support in the Congress for making sure that we have an effective statistical program. We need someone somewhere in the administration who shares the view that we need accurate, timely, comprehensive, and accessible Federal statistical data.

Mr. **Boskin**. You have and will have so long as I am in my job such a person, sir.

Senator **Sarbanes**. Thank you very much.

Thank you, Mr. Chairman.

Representative **Obey**. Thank you, Senator.

Let me simply follow up on that, to emphasize what Senator Sarbanes has been saying. When I sit in the Labor-HHS Appropriations Subcommittee and we try to get more money for BLS or for the Center for Education Statistics or some of the other Labor Department or HHS statistical operations, it's very frustrating.

Last year I had a $12 million package which I was trying to sell our subcommittee, tiny in terms of a trillion dollar budget. We distribute billions and billions of dollars on the basis of the accuracy of those statistics and many of them, when desegregated down to the local level, don't mean bean bag, as you know.

But when you close the doors to those meetings and you mark up in that closed room, you know how many lobbyists there are out in the hall wanting to know what's going on for thousands of other programs? Generally about 200.

You know how many are standing out there saying, "Gee whiz, I hope you can find some room for a good statistical base increase this year"?

Mr. **Boskin**. Hopefully, the president of the American Statistical Association, but probably no one else.

Representative **Obey**. He's not there either. So it's zip. And that means that since every member of the subcommittee has a certain amount of water he's carrying for whatever causes he believes in, that unless we have the big gorilla on the block, the guy down in that big White House saying, "Boys and girls, the country needs this"——

Senator **Sarbanes**. That's not you. You're the junior gorilla on the block.

Mr. **Boskin**. I thought maybe you would use another word besides gorilla, the monkey.

Representative **Obey**. That would be disrespectful.

But let me simply say that we do have to have presidential support on something like this or it just doesn't happen. It's like everything else in this town. We'll jaw on it for 6 years and by then the problem will be twice as bad, so we'll jaw on it some more. We really do have to have an indication that this is an important item.

Let me get back to some questions relating to certain other assumptions in your statement. Let me start by asking, if you go back to the 1981 tax and budget bills that we passed at that time, one of the premises upon which the 1981 tax bill was based is that it would stimulate investment and also savings.

The chart on page 50 of the Economic Report to the President indicates that there was a large increase in capital per worker in manufacturing during the 1970's but no significant increase during the 1980's. And the same pattern appears to hold true roughly for nonmanufacturing.

What is your interpretation of that chart on page 50? Why did the 1981 tax program fail to stimulate investment?

Mr. BOSKIN. Let me just say, sir, that I do not believe the premise is correct that the 1981 tax program failed to stimulate investment.

Representative OBEY. Is the chart wrong then, or what?

Mr. BOSKIN. No. I believe there is some slippage between the statement and the chart, if I may explain, sir.

First of all, we're looking here at the net nonresidential capital stock per worker. And one of the things that we know has happened in the 1980's has been an enormous expansion of employment. So if we looked just at the level of investment, we would see that actual investment increased substantially after the recession.

We entered a recession. Our real interest rates were high. We had a bad recession, and we know that investment plummets during a recession, and that was one of the reasons the recession was so bad. But as we came out of the recession, we had an investment boom actually in 1983-1984, partly reflecting the strong investment incentives in the corporate tax law.

We also have had very high real investment in the last 2 years, real investment meaning divided by the investment goods deflator.

Representative OBEY. What I'm getting at is this: We have a huge amount of capital stock in this country. If we believe that productivity is one of the ways out of our economic problems, then you need to be increasing your investment per worker.

Mr. BOSKIN. Yes.

Representative OBEY. And with all of the promises—I'm leading to something else—my purpose isn't to debate whether we should or should not have, that's not what I am getting at.

Mr. BOSKIN. I agree that we ought to increase investment per worker.

Representative OBEY. The problem is there are all kinds of things that will always happen in an economy. The question is, in the end, does it show up on the bottom line that counts? And the bottom line that counts, it seems to me, in building productivity is the ratio of capital investment per worker.

Mr. BOSKIN. Well, real gross investment as a percentage of gross national product has been quite high for the last couple of years. It boomed in 1983 and 1984 as we came out of the recession. It is certainly the case that at various times there are cyclical influences on it, but if we look, say, at page 62 rather than at page 50, if you look at the top chart and you look at real nonresidential gross-fixed investment, you'll see that for much of the 1970's it was fairly low. It increased a little bit in the late 1970's and early 1980's, and it fell during the recession and it rebounded since then.

There is a lot of controversy in going from the top part to the bottom part.

Representative OBEY. But the net shows you're going down.

Mr. BOSKIN. I was about to refer to that. There's a lot of controversy about referring from the first to the second because there has been a very large increase in the Commerce Department's estimates of depreciation which are the source of some controversy in the economics profession.

But I certainly agree that increasing our rate of investment per worker is quite important. I also think that given we've had a big expansion in the labor force and of employment, and many of those people are people who have entered the labor force for the first time, they should be on a steeper wage profile as their own experience——

Representative OBEY. But a fair summary, then, would be that the tax cut produced some growth in real nonresidential fixed investment on a gross basis; that it does not appear to have done that on a net basis; and that in terms of per worker capital stock growth, that growth did not occur.

Isn't that a fair summary?

Mr. BOSKIN. That is correct, and I should add that I was earlier referring to the structural features of the investment incentives of the early 1980's Tax Act. There also obviously is the fact that we have very large deficits in the 1980's and that those, I believe, partially crowd out private investment.

Representative OBEY. OK. Let me get to what I am leading to. The next question I would ask is this. The chart on page 262 shows a drop in gross savings rate, in gross private during the 1980's, which as I remember, and I remember it quite vividly because I was the author of one of the two alternatives to the tax bill in 1981—I remember that was the claim that was made for that tax cut, that it was going to be turning that around.

Why do you think that happened?

Mr. BOSKIN. I think there are many reasons why the saving rate has fallen. Let me just mention a few. First, the conventionally measured saving rate does not include the saving that is done, for example, in pension funds that may increase in value because they're invested in the stock markets. If we look at the Dow Jones average in 1982 with 770, it's now around 2,300—I haven't checked it since early this morning—that means that a lot of pension funds which were vastly underfunded and which were getting very large contributions put into them became much more fully funded and, hence, the pension contributions fell a lot.

In some of those years in the mid-1980's, the fall in the level of pension contributions which are part of our private saving statistics was over $100 billion. That's one reason.

The second reason is we moved into a period where a growing fraction of our population was in its peak consumption low saving years. The baby-boom generation entered the labor force, was in its 30's and early 40's, periods of time when there is usually, over one life's cycle, a great deal of consumption. As they move into their, say, 50's when typically people save more, we would expect the saving rate to come up some.

Also my own prior research indicates that this generation of people, the baby boom, is saving less at each age than the previous generation, and there are many hypotheses about why that occurs, but that would suggest that as they become a larger and larger fraction of overall income, that it will be hard to get the saving rates up substantially.

So those are some of the reasons. I believe that the targeted tax incentives, like IRA's, were partially but only partially successful. The saving rate would have fallen a little more had we not had universal IRA's. But the notion that the broad across-the-board tax rate cuts would lead to a big increase in saving I believe was always greatly overstated.

Representative **Obey**. I do, too, and I said so at the time.

What I am leading to is this: We were to embark upon what Senator Baker at that time called a river boat gamble and bet that cutting taxes would raise revenues and bet that implementing the tax prescriptions then would increase savings rate and increase investment.

And for a variety of reasons that you have listed, and some others that you haven't, I think none of those things really came to pass, at least certainly not to the degree that we had been told and sold when we passed them.

We are now confronted with a similar situation in the administration's suggestion that we ought to pass the President's capital gains changes. And you say in your statement in several paragraphs, that you think that that action will raise investment incentives, that it will over time increase realizations enough to raise tax revenue.

I would simply like to read to you something which I was given by the House Budget Committee on this point and ask you to comment on it. It says:

> Even if savings and investment go up, it takes a long time for economic output to rise significantly, especially taxable economic output. U.S. stock of capital is very large, so even large increases in investment by historical standards raise that stock slowly. Furthermore, increases in capital stock increase annual output by much smaller amounts than the cost of the capital. The additional capital stock wears out and has to be replaced by some of the increase in output that it helps create. Finally, an increase in stock of capital lowers the market rate of return on capital in comparison to labor. This acts as a natural break on continuing high rates of investment.

Then it goes on to say:

> These latter considerations are illustrated by a 1985 Treasury Department study of capital gains taxation. After making very liberal allowances for a savings response, the Treasury Department estimated that after 20 years the 1978 capital gains reduction, when paid for by offsetting taxes, would raise national income by only 0.06 percent. This is equivalent to raising the average rate of economic growth over the 20-year period by 3/1000 of a percent. This implies in terms of the 1990 economy and budget about $1 billion in additional feedback revenues 20 years hence. That is not an impressive contribution to deficit reduction.

Now, since such a large portion of the President's deficit reduction package is based on an assumption that suggests very large returns to the Treasury by cutting rates on capital gains, how do we—if we do want to remain true to Gramm-Rudman—in fact pass that proposal as suggested by the administration in light of the Treasury analysis of 1985?

Mr. **Boskin**. Sir, let me first respond to the statement you read from. Was it an analysis of the House Budget Committee about the effects of capital formation on the economy? I believe that statement is partially correct. It fails to include the beneficial effects of newer capital or new investment embodying newer technology. And while I wouldn't have major arguments with what it had to say, I think we shouldn't assume that new investment winds up having the exact same contribution as old investment which incorporates older technology. That's a relatively minor point, given what you've led up to.

Second, I think that it is a totally different order of magnitude to be talking about what was a sweeping 25 percent across-the-board rate cut and major changes in the corporate tax in 1981 with this particular proposal, the capital gains proposal.

Representative **Obey**. No. The analysis of the Treasury Department related to the 1978 capital gains reduction.

Mr. **Boskin**. Right. I'm coming to capital gains now. We were earlier talking about the 1981 tax cuts and whether that stimulated investment or not.

The so-called Steiger amendment, the feature of the 1978 tax law that reduced the fraction of long-term capital gains includable for taxable income purposes from 50 to 40 percent and thereby lowered the effective tax rate on capital gains, has been the subject of various analyses. Most of those analyses concluded it raised revenue.

The 1985 Treasury study you cited has been superseded by a 1986 Treasury study which claims to have found serious flaws in the 1985 Treasury study, and I would not speak for the internal workings of the Treasury Department, but I understand that they stand by the 1986 analysis rather than the 1985 analysis.

Representative **Obey**. When are they going to have a new analysis?

Mr. **Boskin**. Well, all that aside—and they also tell me, the revenue estimators tell me what they're doing is consistent with the way they scored capital gains in the 1986 Tax Reform Act. But all that aside, even if we left the capital gains proposal aside or scored it at zero, the President's proposal still meets the Gramm-Rudman-Hollings' target of $100 billion.

The estimate of the deficit is $94.8 billion, and while it is true that the Treasury revenue estimates suggest a shortrun gain of $4.8 billion, that even if we eliminated that $4.8 billion we would still be under the $100 billion. So in that sense, we are not relying on the revenue from capital gains to make the Gramm-Rudman target.

I believe that revenue is one consideration to consider in a capital gains proposal but it is not the only one. Issues of fairness with respect to taking inflationary gains, issues of the efficient allocation of the capital stock and the encouragement or discouragement of entrepreneurship are also important.

I've stated my opinions about that. I'd say that there is some professional disagreement. A distinguished staff member, I guess the chief of your—are you called chief of staff, Joe? What is your official title?

Mr. **Minarik**. Executive director.

Mr. **Boskin**. Executive director of the staff has done some such work, and there is a professional disagreement about this. I'd say the weight of professional opinion is that there is a substantial response of realizations. Many people believe it would be sufficient to more than offset the static revenue loss because the traditional realizations would be taxed at a lower rate. But I do recognize there is a difference of opinion on that matter.

Representative OBEY. I would simply say again that when we are cautioned in your statement to quickly pass your budget, else the economy will not perform as you predict, and when we see that the deficit reduction calculations on the part of the President include almost $5 billion from capital gains, which is subject to considerable controversy as you indicated in terms of whether that will actually be produced, when it's also added to an $11 billion magic asterisk in terms of missing budget cuts, there is a considerable lot of sponge in that outline.

The Post this morning carried an article discussing the administration's S&L plan. The headline reads: "Analysts Call Bush's Plan for S&L's Overly Optimistic." It says, "The analysts responded yesterday to figures released by the White House Office of Management and Budget showing, among other assumptions, that long-term interest rates would fall 3 percentage points in 2 years and that savings and loans deposits would grow at an annual rate of 7.2 percent, even as the government will be curbing high-flying, fast-growing institutions.

" 'These assumptions are highly optimistic, exceedingly optimistic,' said Bert Ely, a financial-institutions analyst in Alexandria. 'They're just not realistic.' "

Robert Litan with Brookings refers to the fact that you are showing government long-term Treasury rates falling from 9.2 to 6.2 which would be the lowest since 1968. And he goes on to say, "To say that that's optimistic is the understatement of the year."

What can you say to convince people like that that in fact you're not running the Government or suggesting that we run it like permanent presidents of optimists' clubs, but in fact are making some hardheaded and realistic assumptions about where this economy is going to go?

Mr. BOSKIN. Let me just say that I believe that the proposals that the Treasury Department put forward and the President put forward form a sound basis both for financing and for reforming the problems of the savings and loan industry. It is my own belief, and I believe it is shared, but I will refer you to Secretary Brady's testimony, that as we move quickly to resolve the problems of the insolvent thrifts, that funds will flow back into the solvent savings and loans, and perhaps that is part of the reason why some people who are dubious as we shut down the worse offenders and the heavily insolvent S&L's perhaps are not paying enough attention to the fact that there has been some flight——

Representative OBEY. You don't think they'll go to money markets and other instruments?

Mr. BOSKIN. I believe there will be a move back into the solvent S&L's as there will be an indication that they have a new insurance fund, that it is solvent, that it is safe. And I believe there has been obviously some indication in recent times that there has been some flight out of S&L's.

Let me then go on to the question of interest rate forecasts as it affects S&L's. The Treasury has in its proposal, in addition to the $90 billion, $40 billion already resolved and the $50 billion that it's going to be raising that has received so much attention, some additional residual capacity. So I believe that the proposals do have the capacity to deal with any unforeseen effects; for example, there being a need to resolve more S&L problem cases than are currently projected perhaps beyond the RTC period.

Representative Obey. My purpose in raising the question is not to question the President's S&L package. I congratulate him for being so quick in coming up with the package, in contrast to his action on the budget where he has presented a ghost instead of a budget.

He has moved quickly and I think responsibly on the S&L front. One can question, as many do, whether he has accurately estimated the cost of it. But my purpose is not to question that package. It is simply again to point out that very thoughtful, responsible, plugged-in people are suggesting that they might not be the assumptions upon which we ought to proceed if we want to prudently protect our efforts to reduce the deficit and make other decisions as well.

Let me ask with respect to the Fed, as you know, Mr. Greenspan during his January 31 testimony made it clear that the Fed wants to slow economic growth or keep economic growth at about 2½ percent. If the Fed is determined that the economy not grow at a greater rate than 2½ percent, does it make any sense for us to suggest that we're going to set up a budget based on an assumption that we grow at 3 percent or more?

Mr. Boskin. I don't believe that Chairman Greenspan has said that he wants to slow economic growth down to 2½ percent. My understanding is he has made several statements that are not exactly that. No. 1, that the long-term sustainable growth rate is probably in the 2½ to 3 percent range, and if productivity grows more than it has recently, then it can well go over 3 percent. I think the phrase he used, he'd like to have that in the bank before counting on it, but he said this is not particularly inconsistent with the administration's growth forecasts.

I believe Chairman Greenspan, as the other members of the Federal Reserve Board, are equally interested in containing and reducing inflation and promoting long-term growth. I believe what they want to do is to make sure that the economy does not get to a stage where inflation is accelerating.

We believe that their prudent action can be consistent with containing inflation and continued substantial growth.

Representative Obey. Let me ask you to respond to several points raised by Mr. Samuelson who has been mentioned once earlier today in the Post this morning, questions which relate to the threat we face from inflation.

He says this:

> It's easy to see why Bush might minimize inflation fears in 1988. The best know inflation indicator, the Consumer Price Index rose 4.4 percent, exactly the same as in 1987. Even if inflation is too high, it doesn't seem to be getting worse. A closer look at economic statistics, however, paints a different picture. It confirms intensifying price pressure.

And then he says:

> Consider, No. 1, that the CPI's stability is misleading. It mostly reflects a drop in oil prices. Excluding energy prices, the CPI rose 4.7 percent in 1988, up from 4.1 percent in 1987 and 3.8 percent in 1986. And in 1989, oil prices are expected to rise, adding to inflation.

How would you respond to that point.

Mr. Boskin. Well, I'm concerned about inflation. I want to make sure we keep inflation contained. I think that Mr. Samuelson is correct to realize that there are particularities of the oil market that, for example, in 1986 caused the overall CPI to be very low, to rise by less than 2 percent because oil prices plummeted.

I think it is hazardous to believe one can forecast accurately oil prices. We didn't forecast the increases in 1973 and 1979 very well, and we didn't forecast the falls in the 1980's particularly accurately, even people whose specialty was the energy business.

My own view is that we have to keep monitoring these data, that some of the broader based measures, not just the Consumer Price Index, but remember the Consumer Price Index measures only a basket of consumer good. There's a lot else in the economy.

The broader based index, the GNP fixed weight deflator, fell between the third and fourth quarter of 1988. But again, we have to be vigilant against inflation. We have to make sure that inflation does not accelerate, and that is why I have thus far supported the moves by the Federal Reserve Board to try to send a signal to financial markets that they will not tolerate an acceleration of inflation.

Whether we have witnessed a short-term temporary increase or whether we are in the early stages of a very small increase that could grow larger and become serious is, I think, a matter of great ambiguity in the statistics, and I believe that it is incumbent upon all of us to study them carefully and if it is indeed the case that inflation is accelerating, to take swift action to prevent that from happening.

Representative Obey. Let me ask again, because as you know, I think the general perception is that there is considerable tension in the opposite direction right now between the administration growth goals and Fed goals.

Samuelson also says:

> The broader measure of price change, the price index, is accelerating. In 1988, it rose 4.5 percent, up from 4 percent in 1987 and 2.7 percent in 1986.

And he points out that labor costs for business rose 4.9 percent in 1988, up from 3.3 percent in 1987 and 3.2 percent in 1986.

The reason I raise this again is that last night, for instance, I noticed Bill Greider and David Evans debating each other. I viscerally often agree with Bill Greider, but my caution makes me listen to David Evans.

It just seems to me that there is considerable danger in basing a budget on an assumption which assumes a higher growth rate than the Federal Reserve seems to be aiming at, especially in light of these numbers. And while I know you're not going to change your view, I have to express my misgivings nonetheless.

Mr. Boskin. Let me just quickly respond. The 1986 number you quoted obviously was reflected by the sharp fall in oil prices there.

You are quite correct that the employment cost index has risen and a part of the acceleration of employment costs in 1988 had to do with increased payroll taxes which were previously legislated, Social Security tax increases; and, second, with a very substantial increase in health insurance premiums.

Part of that came on the benefit side and part of it on the wage side. There is a concern at the Federal Reserve, and I certainly am monitoring this carefully and want to make sure that this doesn't happen, that while long-term inflation is primarily a problem of excessive money creation, of monetary policy, of monetary phenomenon, that one could get a process started, for example, on the wage side with employment costs rising which could get passed on into prices, and they want to make sure that doesn't happen. I think they're being wise to monitor that.

But if we look at the increases, again I think it is important to realize that we're gathering, we're at that stage of the expansion, we're at a stage where numbers are starting to come in, where there is a certain ambiguity and we have to pay careful attention to what is going on.

We would support a policy that tries to prevent an acceleration of inflation, and we do. So I don't think there is any disagreement on that. When Chairman Greenspan says that he thinks that the approximate rate of growth of the economy is the 2½ to 3 percent range——

Representative OBEY. But don't all of these numbers bring into question your assumption on which you ask us to agree and pass the budget; don't they bring into question your assumption about declining interest rates in this environment, and if you are wrong doesn't it mean that we're going to miss the Gramm-Rudman target by a significant amount and not produce the deficit reduction that people think necessary?

Mr. BOSKIN. Again, you mentioned earlier a chicken and egg phenomenon here. Let me just say that if you do produce a substantial deficit reduction package based on these estimates, even if we ex post turn out to be wrong, there should be a substantial decline in interest rates because——

Representative OBEY. No, no. Your're missing my point. My point is we can pass a budget which promises, just like every budget since 1981 promised, that the deficit is going to come down. But if it's based on faulty assumptions, the deficit isn't going to come down and the President and the Congress are going to wind up next year facing a Gramm-Rudman gap twice or three times as large as the one we face this year.

Mr. BOSKIN. You are correct in one of the two statements you made, and I would respectfully disagree with the other. If it turns out the economy does not perform as well, if a deficit reduction package is adopted as we have suggested, then it may well be that the deficit will be higher. And it will be higher, or indeed lower if the economy did much better. It will differ from that being projected, depending on how off the performance the economy is from what is being projected. You are quite correct about that.

But I do believe it is important to realize that what is important, what is even more important is that the actions taken—and I understand you believe there are some problems in getting this process started—you have indicated those quite forcefully and I will take that back to the administration—that the actions taken by the Appropriations Committees and so on put the path of the Federal deficit on a downward course irrespective of whether the economy grows at 2.8 or 2.5 percent, maybe a slightly different downward course.

Representative **Obey**. What I'm getting at is, I'm questioning the accuracy of your statement which seems to suggest that the only way we can meet these very rosy predictions is if we don't pass your budget.

I'm suggesting that it's very possible if we do pass your budget exactly as you sent it down—and that is personally what I think we ought to consider doing—if we did that, I'd like to suggest that if your estimates are wrong, you are not going to get these rosy outcomes that you are suggesting.

And that's why I think, in the interest of the administration, they ought to really ask themselves if they're serious about going down that road.

Let me switch to a different subject. You mentioned Social Security. In December 1988, the Wall Street Journal made the following statement:

> Mr. Boskin has been a critic of the Social Security program. In his book he said the program is inequitable because many wealthy retirees are receiving many times what they and their employers have paid in, plus interest, while it is heavily financed by taxes paid by low- and middle-income workers. In addition, it redistributes the benefits from low- and middle-income two-earner couples to wealthy one-earner couples.

I might suggest that I've seen that comment made by others. Bob Haveman, for instance, from the Institute of Poverty at the University of Wisconsin, has raised some of the same questions and made some similar observations about who has the primary benefit under Social Security.

In light of those comments that you've made in the past, is the Bush administration planning to recommend any changes in Social Security to reduce the benefits of the wealthy?

Mr. **Boskin**. The Bush administration has ruled out any cuts in Social Security. It was the one thing that was left out of the flexible freeze, and it has made clear that full funding of Social Security, including COLA's and benefits for the increased number of retirees are in the budget proposals.

There are, to my knowledge—and I would know—no plans to implement any such changes.

Representative **Obey**. You are pretty much the father of the flexible freeze, as I understand it.

Mr. **Boskin**. I was involved. I don't know if it's my progeny or not.

Representative **Obey**. Tell me, without straining Webster's dictionary how do we define a freeze as one which reduces domestic programs by $11 to $20 billion and provides the military budget with a cost of increase? How do we define that as a freeze?

Mr. **Boskin**. As indicated throughout the campaign and as indicated in the budget, the idea of the freeze and what is flexible about it is several things. First of all, setting priorities. So while the idea was for the overall level of spending to grow only at a very modest rate, and that was what was frozen, that within that some programs could grow more rapidly if others grew less rapidly or were cut.

What is being demonstrated in this proposal, which I think is quite consistent with a flexible freeze, is the President has laid out about $11 or $12 billion of very high-priority increases and new programs and intitiatives that he thinks are very important and the funding is coming in a variety of ways. There's the growth of revenues, the programs that decline automatically, like the farm program, unless there's another drought, and some reforms in various programs. And he has put into a category a whole set of programs that he would like to negotiate an aggregate spending level for while allowing a subflexible freeze within that to have some programs grow more rapidly and others less rapidly.

Representative OBEY. You know what?

Mr. BOSKIN. What?

Representative OBEY. If I were trying to explain that to any group in my district, and if I were trying to argue that what I was proposing was a freeze under those circumstances—instead of something which is all flex and no freeze, at least in program terms—the response I would elicit is that there go those politicians moving shells around again.

I don't argue at all with the total dollar amount that the President sets for the budget. But if you really want a budget that is produced fast and meets the President's macroeconomic target, and if he is interested in pushing that within the context of a freeze, I'd suggest that the freeze ought to be just as cold on one side of the refrigerator as it is the other.

On this one, I see programs on the domestic side getting the cold shoulder, and on the military side, letting those programs get out of the box. And I don't think that is going to sell.

If you really want a fast budget, I would suggest that we recognize that the Gramm-Rudman proposal—I mean this Congress did spend—anytime you can get somebody with my credentials agreeing with somebody like Marvin Leath, very different positions on the spectrum—we did at least wrestle for a year and come up with what we thought was a fair definition of pain in budget squeezes. I really would suggest that in terms of fairness to the American people, that the sequestration process available in Gramm-Rudman is far fairer and far more palatable than the suggestions made by the President which really, in spite of the unpaid for grace notes on the domestic side, really clobber many domestic problems while giving the Pentagon an escape hatch.

I have a number of other questions which I would like to ask, but I am running out of time.

You had indicated—well, let me put it this way. For the last 11 months, the Fed has been raising interest rates to restrain the economy and to try to prevent an acceleration of the inflation rate.

Two questions: I think you said that you largely support what the Fed has been doing. Is that right?

Mr. BOSKIN. That's correct.

Representative OBEY. The second question I'd like to ask you is just how interest rate sensitive do you think this economy really is at this point?

Mr. BOSKIN. I think it is fairly interest rate sensitive. Typically the Federal Reserve's actions on interest rates affect the economy with a fairly long lag, like 9 to 12 months or something of that sort. So I think that is one reason we do not appear to have seen a very large impact thus far.

What we have seen is that long-term interest rates have not risen. There are many of us that believe that long-term interest rates are a major determinant of long-term business investment and of housing investment, construction, and that a key to keeping those sectors strong which are vital to our economy and our growth is preventing long-term rates from rising either because real rates rise or inflation or inflationary expectations rise.

So I would expect to see some sensitivity of the economy to these rises cumulate through time. I don't believe it's instantaneous. I think the quick reactions on short-term interest rate movements tend to be people reallocating their portfolios, but the effect on long-term business planning and housing construction operates with a lag.

Representative OBEY. OK. I wish we had more time, but we don't. I thank you very much for your appearance here today. The committee stands adjourned.

[Whereupon, at 1:14 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1989 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 23, 1989

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room 2359, Rayburn House Office Building, Hon. David R. Obey (member of the committee) presiding.

Present: Representatives Obey and Upton.

Also present: Joseph J. Minarik, executive director; and William Buechner and Dale Jahr, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, PRESIDING

Representative **Obey**. Why don't we get started? Mr. Niskanen, I understand you have to leave at 11?

Mr. **Niskanen**. I have to be in court at 11.

Representative **Obey**. As a juror.

Mr. **Niskanen**. As a juror, yes.

Representative **Obey**. Let me simply say before I begin that Congressman Hamilton, the chairman, was expected to be here. He also was in court today, testifying at the North trial, so he didn't think he would be there.

Let me simply say before we begin that these hearings are held in conjunction with the review of the 1989 Economic Report of the President. This morning the committee will focus on a list of problems that will affect the outlook of the U.S. economy this year and into the 1990's, including the health of the U.S. financial system, the rising level of debt in the U.S. economy and the long-term costs of the U.S. budget and trade deficits.

The committee is pleased to have Mr. Benjamin Freidman, professor of economics, Harvard University; Robert Litan, director, Center for Economic Progress and Employment, the Brookings Institution; and William Niskanen, chairman of the Cato Institute and former Member of the Council of Economic Advisers.

I understand that since you have to leave, it would probably be best if you were to go first. We could ask you a few questions and get you out of here. You say you have to be in court at 11. So you'll have to leave here at what time?

Mr. **Niskanen**. 10:40.

Representative **Obey**. OK, go ahead. If you could each summarize your statements in about 10 minutes.

STATEMENT OF WILLIAM A. NISKANEN, CHAIRMAN, THE CATO INSTITUTE

Mr. NISKANEN. My profession has promised too much in terms of our ability to look around the corner of time, and I have no special qualifications as a forecaster. So I'm going to spend my time this morning and the focus of my testimony on some myths that have enormously confused contemporary economic policy. It is much more important to sort out these myths than to pretend that we can predict the future. So let me address at least a half a dozen of them that have contributed to confusion of economic policy.

Two myths, seemingly contrary myths, seem to plague our budget policy. The first is that something awful will happen in the near term if we don't reduce the Federal deficit. That would at least be a useful myth if it led Congress and the administration to do something forceful about the deficit, but it is no longer credible.

The experience of the 1980's makes clear that most of these apocalyptic visions that we have heard about the consequences of Federal deficits are not correct, or at least the apolcalypse has not arrived on schedule. And now we're at a stage where the Federal deficit is regarded as an explanation for almost all of our economic ills. It has been blamed for both the rise in the dollar and the fall in the dollar, for example, and that is an abstraction from economic reality. We should have learned during the 1980's that our prior perspectives enormously overestimated the short-term economic consequences of the deficit.

In addition, one implication of sorting out that issue is that reducing the deficit is not going to solve very many of our economic problems either, and that we are going to have to use a variety of other measures to address other problems.

We have recently heard a revival of a seemingly contrary myth that deficits, at least as conventionally measured, don't matter. Now, that's a more dangerous myth because it induces inaction or it contributes to the normal incentives for inaction on this matter.

The most important reason to be concerned about the deficit over the longer period of time is that it does look like it displaces a certain amount of private investment, either in the United States or abroad by Americans, although not necessarily on a dollar-for-dollar basis. The distribution of these crowding-out effects across the economy have not been very stable, but at least some amount of private investment by Americans either here or abroad seems to have been crowded out.

The consequence of it is that our private wealth has not grown as rapidly as it would otherwise have grown as a consequence of the large Federal deficits.

The question of whether it is important to reduce the deficit depends very much on what the Federal Government is spending its money for. If the deficit has financed an increase in government consumption or, through transfer payments or tax cuts, private consumption, then the deficit will reduce the growth of wealth in the future. In effect, we would be shifting part of the tax burden for financing current private or government consumption to our children and their children by reducing the capital stock that would complement their labor.

If the deficit, however, is financing high-yield government activities, whether they be high-yield investments of different types or expenditures for a system-threatening war, then I see no reason to be concerned about the fact that part of the costs of that activity are financed by borrowing.

So let me conclude on the deficit issue that we should address Federal borrowing in much the same way that a bank would evaluate the loan application by a family or a firm. It would be unusually suspicious of a loan application that is clearly designed to maintain a standard of living, current consumption that the person cannot now or may not in the future afford, but it is much less reason to be suspicious if the person has a claim that he is going to spend the money for some high-yield activity that will yield at least the amount of the interest rate on the debt.

That leads to rather old-fashioned conclusions about our fiscal policy. Under normal circumstances we should probably have a small surplus on our unified budget. We should be prepared to borrow when revenues are temporarily low, such as during a recession. We should be prepared to borrow when the Government faces an unusual surge of high-yield investments. We should be prepared to borrow to finance the extraordinary costs of a system-threatening war. But that none of these conditions apply at the present time.

That leads me to believe that it is not terribly important whether Congress and the administration meet the Gramm-Rudman deadline every year, in that the world is not going to come to an end or there are not going to be any dramatic effects if we don't meet that schedule. But at the same time, it is very important to try to meet the schedule. It's a schedule that has been announced to the world. I think it is important to reduce the deficit on a phased basis over a period of time, and particularly since that schedule has been announced to the world, I think the credibility of Federal fiscal policy is terribly dependent upon it.

In conclusion, reducing the Federal deficit is important to our economic health primarily because it would increase our net saving and investment. At the same time, it's important to recognize that reducing the deficit is not a chicken soup remedy for all of our economic ails and that we have to address a variety of other measures to address those issues.

Another myth that has plagued policy in recent years is the idea that the deregulation of several industries in the late 1970's and the early 1980's is the major reason for the problems of these industries. I think that's a most damaging myth because it's likely to lead to some kind of reregulation, and we will forgo what have been the considerable benefits of deregulation.

A more accurate perspective is that the problems of several industries that have recently been deregulated are primarily due to the fact that the Federal Government did not change its own remaining role in these industries in a way that would complement the deregulation.

Let me first address a simple case. Airline deregulation has enormously increased the frequency of commercial flights. That has caused increasing congestion and delays at major airports. The problem is that the Federal Government sat on its hand basically for 15 years without building a major airport, the delay in modernizing and rationalizing the air traffic control system, and we still do not have a viable means for rationing congested airspace over the major airports. The combination of deregulating fares and entry and the Federal Government basically sitting on its hands in terms of the airports and airspace and airways had led to a substantial increase in congestion. But the right response to that is for the Federal Government to put its own act in order by rationalizing its own remaining role in the industry, rather than reregulating airlines and losing what have been the considerable benefits, maybe on the order of $15 billion a year from the deregulation of prices and entry.

Now, there is a much more severe problem, of course, in our depository institutions. In this case, the Federal Government deregulated deposit rates and substantially increased deposit insurance in the 1980 act, but it did not change the nature of the deposit insurance system and it did not change what is a very complex web of laws, policies, and regulations that have cartelized the financial system by line of business and by region.

The combination of these measures has led to a high rate of bank failures in the 1980's, and it has unfortunately led, and will almost surely lead to a very high taxpayer bailout of the savings deposits. But the problem here is not due to the deregulation of deposit rates. It is due to the fact that the Federal Government didn't change the nature of the deposit insurance system at the same time that it both deregulated deposit rates and increased the amount of deposit insurance.

In the long run, that situation is not sustainable even for the commercial banks, in that the combination of deregulated deposit rates and flat-rate deposit insurance, which is in effect unlimited, is not viable over the long run. And, of course, the long run for the savings banks happened some years ago, and we're already seeing the consequences.

I regret, however, that the apparent response by the Bush administration to this matter is some amount of reregulation. They deserve credit for moving quickly to close some of the savings banks, but their approach toward the longer term problem seems to be some form of regulation of the portfolio of banks rather than sorting out the fundamental problems of the deposit insurance system and the continued cartelization of our overall financial system.

Two myths have plagued trade policy. One myth is that trade policy by iteself can reduce the trade deficit; that some way, by restricting imports or by promoting exports or trying to open up foreign markets, we can reduce the trade deficit. Now, that's a very dangerous myth. We can do all kinds of things with the composition of trade by trade policy. We can change the product composition of trade. We can change bilaterial balances. We can change the total level of trade up or down. But one thing we can't do with trade policy alone is to affect the trade balance, because the trade balance is the difference between savings by Americans and investments in the United States, and trade policy by itself doesn't have much effect on that saving-investment balance.

The United States runs a big trade deficit because we have a low saving rate and a moderately high investment rate. That will continue to be the case until we either increase our savings or reduce our investment.

There's a related myth that is also very dangerous that the trade deficit by itself is a major problem. It's more accurate to perceive the trade deficit as derivative from a problem, and the problem is our unusually low net saving rate, but that given our low net saving rate, we are much better off with a trade deficit than without a trade deficit.

The trade deficit should be regarded as a blessing. The fact that investors from other nations are willing to invest in the United States to complement our very low savings rate should be recognized as a blessing and not as a problem by itself.

There is one measure that Congress is now considering that would have a very strong effect on the trade deficit, but with disastrous consequences, and that's the Bryant amendment. The Bryant amendment, by implementing a registration requirement system for foreign investors, is very likely to scare away foreign investors in the United States. That will reduce our American trade deficit, but it will also reduce the total level of investment in the United States. We'll have higher real interest rates. I'm telling you that we wouldn't like these consequences even if the trade deficit declines.

Let me conclude by discussing another myth that has popped up in the testimony of Federal Reserve officials and is now becoming a favorite theme in the economic press, and that's the idea that growth somehow causes inflation and that if we grow more than 2½ percent a year in real output, somehow that will increase the inflation rate.

Now, that's really crazy. That's not only confused, it's perverse. For any given level of demand in the United States, increased growth reduces inflation. So the focus of the Federal Reserve should be on the growth of current or nominal demand in the United States, not on the growth of real output.

Let me say that I think the performance of the Fed in this decade has been extraordinarily good, and I also want to reinforce the recent behavior of the Fed, in that I think that it is important to try to constrain the growth of the demand in the near future. It has been growing more rapidly in 1988 and particularly in the fall quarter of 1988 than is consistent with a stable inflation rate, let alone a declining inflation rate. And the Fed has had, I think, a very good record for most of this decade, and I endorse their recent policy.

I worry, however, about this rhetoric which we hear from both Fed officials and other that somehow it is dangerous for us to grow more rapidly than, say, 2½ percent a year. There is no stable relationship between nominal or current dollar values or levels in the American economy and real conditions in the American economy.

We should ask the Fed to maintain a stable path of domestic demand, preferably reducing the growth of that path so that in the not-too-distant future we can maintain a steady price level, but that if we happen to have higher real growth in a particular year than they expect, then both we and they should bless that condition and not somehow ring our hands about that condition.

My worry in this case is that some people at the Fed may believe this rhetoric, although I think their record to date has been remarkably good.

Let me conclude briefly. May I suggest that this committee is best advised to try to sort out the myths that confuse our current economic policy than to expect to be able to provide very good forecasts of the future. The future will always be uncertain. In part, it will be a consequence of our own making, depending upon how well we sort out these current economic issues.

Let's try to understand the world as it is and sort out what have been the slogans that have confused a good bit of our economic policy for many years.

Thank you.

[The prepared statement of Mr. Niskanen follows:]

PREPARED STATEMENT OF WILLIAM A. NISKANEN

SOME MYTHS THAT CONFUSE ECONOMIC POLICY

Chairman Hamilton and members: I am pleased to testify again to this thoughtful committee, especially as a private economist.

My profession has promised too much in terms of our ability to look around the corner of time, and I have no special qualifications as a forecaster. In addition, making better policy decisions now is both more important than making better forecasts and is not very dependent on better forecasts. For these reasons, my testimony addresses and tries to resolve several myths that have confused federal budget, regulatory, trade, and monetary policies.

A. The Effects of Federal Deficits on the Economy

Federal budget policy has been confused by two contrary myths:

1. Federal Deficits Will Lead to Severe Economic Effects in the Near Term

Although this view may be useful to encourage prompt action to reduce the deficit, it is no longer credible. At various times during the first half of this decade, for example, we heard dire warnings that the increasing deficit would increase inflation, interest rates, and the exchange rate and would reduce domestic investment and economic growth. During the past several years, the still-large deficit has been blamed for both the trade deficit and the decline in the dollar exchange rate. As it turned out, there was no substantial effect of changes in the federal deficit on any one of these conditions. Inflation and interest rates have declined sharply since 1981. The dollar exchange rate increased sharply until early 1985 and has since declined sharply without much relation to the deficit. Domestic investment has been moderately strong and the current recovery is the longest peacetime recovery on record. The federal deficit appears to provide very little useful information about the economic effects of fiscal policy.

2. Deficits Do Not Matter

The economic history of this decade has led to a recent revival of the view that deficits (at least as conventionally measured) do not matter. This view is also a myth but one that is more dangerous. For a given level of total demand, federal deficits "crowd out" an equal level of spending somewhere in the economy--some combination of state and local spending, private consumption, domestic investment, and net foreign investment. The economic effects of federal deficits depend importantly on what other spending is reduced, but the allocation of these crowding-out effects has not been very stable. An increase in the federal deficit, however, appears to reduce total investment by Americans by some amount, either in the U.S. or abroad; the specific effects on domestic investment and on our net foreign investment, however, depends on the relative real post-tax returns in the U.S. and abroad, conditions that are not much affected by the deficit.

The economic effects of federal deficits also depend importantly on what type of spending is increased by an increase in the deficit. A deficit that results from measures that increase current private or government consumption would reduce the capital stock and real income of future Americans; from my perspective, such deficits are fundamentally immoral. A deficit that results from a temporary increase in spending to finance high-yield government investments or a system-threatening war, however, would increase the real income of future Americans, even if it crowds out some amount of private investment.

Again, the level or change in the federal deficit, by itself, provides very little information about either its economic effects or whether it is appropriate. One must look at both the "crowding-out" and "crowding-in" effects of a specific deficit, conditions that are very dependent on the details of the budget and the tax code. In summary, I suggest, one should evaluate a federal deficit by the same standards that one should apply to borrowing by a family or a firm. One should not borrow to maintain or increase current consumption unless one's income is only temporarily low or one is prepared to reduce future consumption by more than the increase in current consumption. One should not borrow even for investment unless there is reason to expect that investment to have a higher return than the interest rate on the increased debt. These are simple truths that have been only confused by much of contemporary economics.

For the federal government, the general implication of this perspective is that the unified budget should have a small surplus under normal conditions. Deficits, in turn, should only be used to finance the temporary loss of revenues during a recession, an unusually-high level of government investments, or the extraordinary costs of a system-threatening war. For the long-run, we probably need to constitutional amendment that would require a super majority of Congress to increase the public debt or taxes. For the next few years, we should reaffirm the commitment to stay on the Gramm-Rudman deficit-reduction schedule without any tax increase that would reduce private saving and investment. The implication of my response to the first deficit myth is that it is not very important if we do not meet this schedule in a specific year. The implication of my response to the second deficit myth is that it is very important to try to stay on this announced schedule.

A continued federal deficit is more like a slowly-acting cancer than like racing toward a cliff. Reducing the federal deficit is important to our economic health, primarily to increase our net saving and investment. At the same time, reducing the deficit is not a "chicken soup" remedy for all of our perceived economic ills; other measures are necessary to address other problems.

B. The Effects of Economic Deregulation

Another myth that has confused federal policy is that the developing problems of several industries are due to the recent deregulation of these industries. These problems, however, are more directly attributable to the failure of the federal government to change its own remaining role in these industries. Unless these issues are sorted out, we face the prospect of some type of reregulation and a new set of problems.

The deregulation of prices and entry in domestic aviation, for example, has substantially increased the number of commercial flights, generating large benefits to both air travelers and the airlines. Although the increase in flights has not compromised air safety, it has increased congestion and delays at some major airports. The congestion problem, however, is primarily due to a failure of the federal government to rationalize its own activities supporting this industry. No major new airport was initiated for 15 years. Rationalization and modernization of the air traffic control system was delayed. The government still rations congested airspace and landing slots the way the Soviets run their economy--and with much the same effects. The Department of Transportation even overrode a landing-fee schedule at Logan airport that was designed to encourage smaller planes to use other airports. These problems will not be resolved until the federal government creates property rights in congested airspace, grants local airport authorities the full right to set landing fees, and commits the balance in the airports and airways trust fund to increasing the capacity of airports and the air traffic control system.

Our depository institutions, of course, face much more serious problems. The deregulation of deposit rates substantially increased the rates available to small depositors in a period when average loan rates substantially declined, creating substantial benefits to both savers and borrowers. In the long run, however, the deregulation of deposit rates is not compatible with the current system of deposit insurance, because banks with a low-or-negative net worth have an incentive to make high-risk loans, the down-side risks of which are borne by the deposit insurance funds and, ultimately, the taxpayers. For the savings banks, of course, the long run started several years ago. Although this problem has been recognized for many years, the federal government has yet to address the steps to resolve this problem. The government has been very slow to close insolvent banks, and most failed banks were closed in a way that effectively extends deposit insurance to all deposits and, in some cases, to other creditors. Deposit insurance premiums and capital ratios are still independent of the risk of a bank's loan portfolio. Federal laws and regulations still segment the financial industry by line of business and region, increasing the vulnerability of banks to problems of a specific sector or region. The Bush administration deserves credit for moving quickly to close more savings banks, a measure that will necessarily land to high costs to the taxpayers, but they have yet to address the measures that would prevent a continuation of these problems for both the savings and commercial banks.

C. The Relation of Trade Policy and the Trade Deficit

Another myth that has confused federal policy is that a more aggressive trade policy--by restricting imports, opening foreign markets, or subsidizing exports--would reduce the U.S. trade deficit. Such trade measures may affect the product composition of trade and the bilateral balances with specific nations but would have no effect on the total trade deficit. Our (broadly-defined) trade deficit is equal to net saving by Americans (private saving minus government borrowing) minus total investment in the U.S. Our total trade deficit, thus, can only be reduced by increasing net saving or reducing domestic investment, conditions that are independent of trade policy. Our more aggressive recent trade policy serves only the interests of specific import-competing or export industries, at the expense of American consumers and taxpayers. It has also depreciated our political capital with our major allies, usually over trivial issues, that is more important to use on other issues.

A related myth is that our trade deficit and the resulting net foreign investment in the U.S. is a major problem. Our current trade deficit, is more accurately recognized as derivative of a major problem--the fact that our net saving rate is so low. Given our low net saving rate, the trade deficit should be recognized as a blessing. In the absence of the trade deficit, U.S. interest rates would be much higher and investment in the U.S. would be reduced to the level of our net saving. Measures that would discourage or restrict foreign investment in the U.S. would reduce the trade deficit only by reducing domestic investment. A more appropriate response would be to reduce the federal deficit by means that do not reduce either saving or investment and to remove the remaining biases in our tax code against private saving.

D. The Relation of Real and Nominal Economic Conditions

Recent discussions of monetary policy--by the Federal Reserve, the Congressional Budget Office, and in the economic press--have revived the strange myth that growth causes inflation. This myth is not merely confused; it is perverse. For any given level of demand in the U.S., an increase in real growth reduces inflation. The primary responsibility of the Federal Reserve is to maintain a steady path of domestic demand, preferably reducing the growth of this path gradually to achieve a stable price level. If the Federal Reserve adequately performs this role, they and we should welcome a higher growth of output. The developing view that the U.S.

economy cannot growth faster than a 2.5 percent annual rate without increasing inflation has no basis in either economic theory or the historical evidence. My own view is that the performance of the Federal Reserve has been remarkably good in this decade, but I worry about this type of rhetoric. I have probed members of the Federal Open Market Committee to determine whether they believe this rhetoric and can only report that there is a substantial disagreement in this group on this issue. This committee would also be well advised to probe the Federal Reserve to determine their basis for this strange perspective.

E. Conclusion

In conclusion, may I suggest that this committee is best advised to try to sort out the myths that confuse current economic policy than to try to look around the corner of time. The future will always be uncertain, economic theory is imperfect, and current economic data are often confusing. At best, we can improve economic policy only on a sequential basis--implementing those measures that we believe are the most important next steps and then learning from our successes and failures. Future economic conditions will depend on the direction of these next steps and our ability to learn from their effects. The beginning of wisdom, however, is to try to understand the world as it is, a task that requires sorting out the several myths that may lead economic policy in the wrong direction.

Thank you.

Representative **Obey**. Let me simply ask a very few questions—and Congressman Upton will have a few—so that you can leave early.

First of all, your comments on trade. I think what you said orally here this morning is a bit different than what you said in your prepared statement, and I think I agree with what you said orally if my interpretation of it as being slightly different than what you said in your prepared statement is correct; because in your prepared statement your said:

> Another myth that has confused Federal policy is that more aggressive policy would reduce the U.S. trade deficit. Such trade measures may affect the product composition of trade and the bilateral balances with specific nations would have no effect on the total trade deficit.

Whereas when you summarized your remarks, you said we can't do it with trade policy alone and that trade policy doesn't have much effect.

I simply want to tie down which statement you want to defend because it's my view that the world is not static; that, for instance, if a corrugated cardboard splicing manufacturer in my district winds up selling three additional machines to Japan this year because they dropped barriers which they've had to that kind of machinery in the past, and if as a result of that he's able to hire eight more people, and they save money and they invest, and he makes more profit and is able to invest, that does in fact have an affect on the trade deficit because we're expanding long term our own investment.

Why isn't that correct?

Mr. **Niskanen**. Congressman Obey, my written remarks were more careful than my oral remarks. Trade policy can affect the level of trade but it can't by itself affect the trade deficit. If trade policy is trade expanding, it will increase both our exports and our imports. If trade policy is restrictive, it will reduce both our exports and our imports. But it can't affect the deficit.

The deficit is basically made in America in the sense that——

Representative **Obey**. I don't argue with that. I agree that it is basically made in America. We said that in the committee report 3 years ago.

But what I have difficulty following is this: If you assume that the world is static and that there are no results from actions, then I would agree with you. But it seems to me that if we are able to expand exports to a specific country because they drop trade barriers, then it seems to me that that in turn allows us to make more profits, which allows in the future for additional investments which can help reduce that trade deficit. Isn't that true?

Mr. **Niskanen**. It won't reduce the trade deficit because it will lead to a corresponding increase in our imports unless the measure affects the saving and investment balance.

Representative **Obey**. But you're making an assumption that every dollar of that increased profit will wind up going to increases in imports.

Mr. **Niskanen**. It will go to an increase in imports unless it affects how much Americans save or how much people want to invest in the United States.

Representative **Obey**. I would grant that, but I think that is something different than saying that it has no effect on the trade deficit.

Mr. **Niskanen**. I'm saying it will have no effect on the trade deficit unless it affects the savings and investment balance.

Representative **Obey**. With that I don't argue.

Mr. **Niskanen**. It may affect the saving and investment balance in a way that actually makes the trade deficit increase. For example, if our export sector booms and it leads to higher investment in our export sector, that by itself can make the trade deficit change in a way that is different from what you think, because you have to affect the saving and investment balance in order to affect the trade deficit.

So trade policy itself may have effects which we would regard as favorable and it can have, in many cases, effects that I would regard as most unfavorable. But one thing we should not expect trade policy itself to do is to affect the balance as distinct from the level of trade.

Representative **Obey**. I'm not suggesting that it does. But I do challenge the assertion that there is absolutely no effect, because I think you have to build in certain assumptions about what happens after a fall in another country's trade barriers.

Mr. **Niskanen**. I will say that it has no effect unless it affects the saving and investment balance.

Representative **Obey**. Ok.

Mr. **Niskanen**. In that case, then, you have to think through the effects of the trade measures on the saving and investment balance, and there may be some effects. It may work in a different direction than you might think.

Now, the measures that affect the relative attractiveness of the American investment climate or measures that particularly affect the willingness of foreigners to invest in the United States can have dramatic effects on the trade balance, but let me tell you that you won't like the consequences of those effects.

If foreign investment in the United States stopped, total investment in the United States would have to fall to the level of American savings, and we would have much higher real interest rates than we would otherwise.

And so be careful, be careful about measures that would reduce the attractiveness of the American investment climate either to American investors or to foreign investors.

If the trade deficit becomes an overriding goal, it is very likely to lead to measures that would have really quite unfortunate consequences.

Representative **Obey**. Let me ask you about your comments on Gramm-Rudman. You indicated that you thought it was not necessary to hit a specific target at each moment in the process, but that we ought to be sticking to the general guidelines over time.

How would you then view the administration's decision on the savings and loan package to borrow the money indirectly rather than directly at a cost which was estimated to be anywhere from $2 to $4 billion more over the life of those loans?

Mr. **Niskanen**. I see no reason not to use regular Treasury debt to close these savings banks. At the same time, I would support putting the principal of that debt off budget, in that it does not reflect an increase in total liabilities. The liabilities are already there, and issuing more debt, whether it's either Treasury debt or agency debt, just puts that debt on the books. The liabilities are already there.

So I would have no reservation about keeping the amount of borrowing to close the savings banks off the Gramm-Rudman schedule, but I see no reason not to use regular Treasury debt to finance that amount.

Representative OBEY. Do you have any judgment about the arguments that we are getting on a daily basis that this packet either is or is not adequate enough? Several of the prepared statements that you gentlemen presented made quite clear that we don't want to repeat the mistakes that were made earlier in the cycle when we didn't fix up the problem when it was more manageable and now we're faced with a bigger mess.

Mr. NISKANEN. I don't have a good personal judgment about that. The man whose forecasts have proved to be most accurate has been a regular contributor to Cato—Bert Ely. His forecasts have proved to be most accurate about this problem, and I would tend to respect his judgment about the total magnitude of the issue.

The ultimate magnitude of the issue is not terribly important to try to pin down right now, basically impossible to pin down. The important thing to do is to take the right steps now, and I think that means closing these banks as quickly as possible, even in fiscal 1989 if possible, without worrying very much about trying to fold them into other banks.

The basic reason for acting quickly is that the liabilities are increasing at a faster rate than the interest rate on Federal bonds. Liabilities are apparently increasing at an annual rate of about 20 percent, a billion or so a month, whereas the Federal Government can borrow long at 9 percent. So that leads me to the conclusion that we ought to move very quickly. We ought to be willing to borrow a lot of money very early and close these banks so the continued increase in these liabilities is stopped.

I don't think it's terribly important to try to sort out how big that bill is going to be because we just can't do it. We're going to have a big taxpayer hit, but I see no alternative to that. But the taxpayers have the right to insist that as part of that package there be a sufficient reform that this isn't going to happen again and it isn't going to spread to the commercial banks. And I don't see that yet in the Bush package.

The Bush package has moved fairly quickly on the closing of the savings banks, but I don't see the kind of reform in the deposit insurance system and in our regulations of the savings and commercial banks that would prevent this problem from happening again or spreading.

At most, what the Bush people seem to have done is to make the regulation of savings banks more like the regulation of commercial banks. We've had a high rate of commercial bank failure in this decade as well, and there isn't anything fundamentally different in the problems of the deposit insurance system of the FDIC as of the FSLIC.

Representative OBEY. Thank you.

There are a number of other questions I would like to ask you, but we're rapidly running out of your time.

Congressman Upton.

Representative UPTON. Thank you, Mr. Chairman.

Because of the interests of time I'd like to ask just two questions. One to go back to your statement with regard to the Bryant amendment, I opposed the Bryant amendment when it was up last year.

But to play devil's advocate for a second, of course the argument on the other side is that it's just a simple reporting question, and it passed overwhelmingly in the House.

Have you done any studies to counter that argument with regard to that?

Mr. NISKANEN. On its face, it's just a simple reporting requirement, but it looks to me very much like the early stages of what Canada did in the Foreign Investment Registration Act—FIRA. That act, implemented in the Trudeau government, knocked 20 cents or so off the Canadian dollar by scaring away foreign investors and it ultimately led, of course, to much more than just registration and information. It ultimately led to restrictions on foreign investment in certain sectors of the Canadian economy.

We don't have much experience in which to make an estimate for the United States of its consequences. But it looks very much like, as I said, what the Trudeau government did in Canada with I think quite adverse consequences.

Representative UPTON. My other question I had is with regard to the trade deficit. I think most Members of Congress are concerned about the levels of trade deficit we've seen in the last 4 or 5 years in particular.

You talked a little bit earlier about how it's sort of been beneficial, especially with the rising budget deficit that we've had; yet we've seen the lowering of the prime rate, increase in the growth rate. Unemployment, of course, is down.

What do you think we should do to reduce the trade deficit other than reducing the budget deficit? And what I'd like you to think about here is, though you weren't with the administration when the trade bill was up, the last 2 years really—of course, the Reagan administration strongly opposed the trade bill which I viewed, frankly, as a free but fair trade bill. The Gephardt amendment was struck. Your comments indicate you certainly supported that.

Why was it that the Reagan administration would have opposed a free but fair trade bill in light of the impending trade deficit that we have?

Mr. NISKANEN. Well, two things. The most desirable measures that would have some effect in reducing the trade deficit would be to get the Federal Government deficit under control, bring it down on a steady basis, but—importantly—by means that do not reduce domestic saving and investment.

Second, I think we should think seriously about removing the remaining biases in our Tax Code against private savings. If we did both of those things, then I wouldn't worry about the magnitude of our trade deficit.

The United States ran a trade deficit for 300 years, from the time of the Pilgrims until World War I. Fortunately, we didn't have a Department of Commerce to keep numbers on it. And that was part of the reason for the American success story.

Foreigners were willing to invest in the United States, in our railroads and chemical plants and breweries and American industry, and that went on, as I say, for three centuries, to the great benefit of the United States. Fortunately, as I say, we didn't keep numbers on it and we didn't worry about it.

If we get our own act in order, if we put our own fiscal house in order, then I think we shouldn't worry about the trade deficit.

Now, the Omnibus Trade Act of 1988, if I had still been in the Government I would have strongly opposed it, and I did in fact editorialize strongly against it. Its primary problem is that it represents a unilateral declaration of the rules of trade. It basically tells the rest of the world, "play by our rules or we're not going to trade with you."

That is my primary concern about it. I think the only meaning of fair trade is trade that is consistent with rules that have been agreed to by all affected parties. The 1988 Trade Act, in that sense, was profoundly and fundamentally unfair in that it was a unilateral declaration of the rules of trade. And to that extent, it represents a major depature from the leadership, primarily by Democrats, starting with Cordell Hull in 1934, toward a world trading system based upon mutually agreed rules of trade.

The 1988 Trade Act was correctly described as procedural protectionism. It does not by itself implement any new tariffs or quotas but it has clearly greatly raised the expectations of both Congress and certain parts of American industry for more aggressive trade policy by the USTR, particularly in the use of the new super 301 provision.

I did oppose the Trade Act of 1988. I think it was bad law. It has led to unrealistic expectations about its effects, and unfortunately it has led to most unfortunate expectations about future trade policy.

Thank you, gentlemen. I must go for another obligation.

Representative OBEY. Thank you very much.

Could we hear next from Mr. Litan?

STATEMENT OF ROBERT E. LITAN, SENIOR FELLOW AND DIRECTOR, CENTER FOR ECONOMIC PROGRESS AND EMPLOYMENT, ECONOMIC STUDIES PROGRAM, THE BROOKINGS INSTITUTION

Mr. LITAN. Thank you very much, Mr. Chairman.

I concentrated in my prepared statement on three issues: the health of the U.S. financial system, increasing corporate leverage, and longrun productivity issues. I will attempt to briefly summarize what unfortunately turned out to be a rather long statement.

Figures 1 and 2 in my prepared statement highlight the growing rash of bank failures and savings and loan failures in the United States in the 1980's. Quite obviously the drop in energy and agricultural prices in the Midwest and Southwest had much to do with these trends. But many also pin the blame for the rising failure rate on deregulation. It's an issue that Bill Niskanen addressed, and since there has been so much confusion about it, I'd like to try to clear some of it up.

In fact, two forms of financial deregulation in this decade clearly enhanced bank and thirft safety. When we removed controls on interest rates that banks and thrifts could pay in the early 1980's, we helped halt a potentially debilitating run to money market funds.

And, similarly, the gradual move by the States to allow bank entry from other States has also promoted safety-enhancing diversification. Now, in fairness, many critics of deregulation recognize these points but point their fingers at so-called product deregulation, or broader powers, and inadequate supervision as the real villains in the thrift crisis in particular.

Clearly, the attacks on weak supervision are right on target. Between 1980 and 1984, the numbers of thrift examiners were slashed, and bank regulators, too, also missed their share of imprudence and fraud in the 1980's. The criticism against broader thrift powers, however, needs to be put in some perspective.

Remember, Congress let federally chartered thrifts into the consumer and business lending business in the early 1980's to help them diversify away from long-term mortgages and thus to better withstand interest rate shocks.

Now, it has turned out that California, Florida, Texas, and some other States have gone even further than the Federal Government and have allowed their State-chartered thrifts into all kinds of businesses. In fact, this is shown in table 2 of my prepared statement.

This trend raises some important questions. For example, to what extent do we want Federal deposit insurance to subsidize thrift entry into commercial ventures? But to focus on broader powers as the "reason" for thrift problems is to miss the forest for the trees.

If there is any single lesson we should draw from the thrift disaster of the 1980's, it is this. We let people into this industry with too little capital: 3 percent of assets under very lenient, some would say fraudulent, accounting standards, rather than the 6 percent required for banks, which invited the thrift owners to leverage their investments by 30 or 40 times.

Then when many thrifts quite predictably went broke, we not only allowed them to remain in business, but we allowed them to double their deposit base from $100 to $200 billion in the space of 3 years.

Is it any surprise that these insolvent thrifts then blew much of the additional $100 billion in many of these risky ventures that have been allowed under State and Federal law?

Remember the Fram oil filter commercial some years ago, with the guy on TV saying that you could pay something like $20 for an oil filter now or $400 for an engine overhaul later. Well, that commercial has much to teach us. In 1985 we could have put up about $20 billion, by my estimate, admittedly a lot of money, foreclosing or merging the roughly 500 insolvent thrifts at that time. But instead we waited. In effect, we let bankrupt people take up to $200 billion of Washington guaranteed money to the thrift equivalent of Las Vegas. And so now we face a thrift engine overhaul of over $100 billion.

In sum, the central villain in my view in the thrift crisis is our failure to enforce capital standards, not broader powers per se.

Table 2 of my prepared statement shows that well-capitalized thrifts have not jumped massively into nontraditional investments. But for weak or insolvent thrifts, the mixture of broader powers and insured funds was like putting a torch to a tank of gasoline.

The administration's $50 billion rescue plan will certainly help clean up the mess, but the plan has several shortcomings. As I outline in some detail in appendix A of my prepared statement, I believe that $50 billion will not be enough. It will take just that much money to close the 350 so-called GAAP insolvent institutions now operating, and it will take even more money to clean up a lot of the so-called market value insolvent institutions that may look healthy under GAAP standards.

Second, since the thrift crisis is growing in magnitude every month, stretching out the borrowing over 3 years is a mistake. There is simply no reason why the FDIC and FSLIC cannot auction off or close all of the GAAP insolvent institutions in 2 years or less if they had the money.

Third, it will cost society by my estimate an extra $2 billion in additional interest to raise the money through an off-budget device. I point out in my prepared statement that Treasury bonds could have been used without running into Gramm-Rudman problems either by not recording the bond principal on budget, which you can do for sound macroeconomic reasons, or by waiving the Gramm-Rudman targets specifically for this purpose.

The administration's rescue plan offers several fundamental reforms to prevent another crisis. By far the most important in my opinion is the recommendation that would require thrifts to meet bank capital standards by June 1991.

I am sure you have heard, Mr. Chairman, many in the thrift industry complaining that this proposal could put as many as 1,000 more thrifts out of business because they can't meet the requirement. I urge you in the strongest way I can to ignore these complaints, even if it costs more money up front to close additional institutions. If there's one thing you should remember, it's the Fram commercial. But here, too, more should be done.

First, the Bush plan proposes to give the capital standard some teeth by authorizing regulators to put weakly capitalized but still technically solvent institutions into receivership. This so-called early intervention mechanism should be mandatory so that regulators will have the statutory responsibility, insulated from political pressure, to step into institutions before they become insolvent.

Second, regulators should move toward market value accounting for both banks and thrifts, which in my view would provide regulators and the public far more realistic measures of financial conditions than GAAP.

Finally, one remark about lower deposit insurance ceilings. This is a suggestion that appeared in the Economic Report. Some people have talked about it. Treasury wants to study it. This is a nice idea in theory; it's not going to work in practice. And I'll tell you why. If you lower the ceiling from $100,000 to, say, $50,000, then people are going to break up their accounts into smaller chunks. Instead of $95,000, they'll put them into $45,000 chunks.

Our government has made clear throughout this decade that we are going to protect the uninsured creditors at large failing institutions like Continental, like American Savings & Loan, First Republic, and so forth. So we're already guaranteeing uninsured creditors. It doesn't make any difference if you lower the insurance ceiling if the Government is already committed to protecting uninsured creditors and people expect that.

The only way you're going to get discipline in my view is to have tough capital standards and give the regulators the mandatory responsibility to step in early, before these institutions become solvent, and take those institutions away from them.

Now, I want to turn briefly to the second issue, increasing corporate leverage, which has aroused a lot of concern primarily because of the fear in the event of another recession or another rise in interest rates, or both, we'll he hit by a wave of corporate bankruptcies which could shatter business and consumer confidence.

Alternatively, as Ben Friedman has argued and will probably tell you today, the Federal Reserve could be so worried about this outcome that it will err on the side of allowing too much inflation. These are valid concerns but there are also offsetting considerations.

As I show in figure 3 of my prepared statement, the sharp increase in business bankruptcies in the 1980's, especially since the recession ended in 1982, demonstrates that our economy can grow at quite a healthy pace, despite a rising trend of business failures.

As the Texaco and Johns-Manville bankruptcies amply demonstrate, life can go on and employees can continue to work, even while a bankruptcy judge supervises the restructuring of the rights of shareholders and creditors. More often the required reorganization takes place voluntarily. Still, these are no reasons to be complacent.

I don't think economists or anyone else can tell you how the economy would react in the event of another recession if we had a massive wave of bankruptcies. For this reason policymakers are right to look for ways to cure the bias in our Tax Code that tilts corporate financing toward debt. Unfortunately, you also have a large budget deficit problem and if you're going to do this, you have to do it in a revenue neutral way.

I list in my prepared statement a number of ways that would fix the Tax Code to correct this bias and I won't go into them in detail at this point. But let me just point out one thing. Each proposal that has been advanced has vigorous advocates and detractors. The Congress, wisely so I think, appears reluctant to take firm action on any of these proposals until it has a greater understanding of how each would effect the economy and how difficult transition issues could be resolved.

So I give you a suggestion and please don't laugh. It is that Congress commission a study, perhaps by the Congressional Budget Office or some outside experts, to run a horse race to compare all of the various plans for ridding the corporate Tax Code of its bias toward debt in a revenue neutral fashion. Such a study should compare the proposals on at least the following dimensions: their effects on different industries, aggregate investment, new business formation, innovation, and any distortions they might introduce into private sector decisionmaking.

The final issue I want to address somewhat briefly is the longrun economic challenge that we all face in maximizing the growth in living standards. The key to advancing living standards is to increase productivity, but as this committee is well aware, our productivity growth performance in recent years has been disappointing.

As Martin Bailey and Margaret Blair point out in a recent Brookings study that I coedited, if private sector productivity had grown since 1966 at the 3.2 percent rate at which it advanced from 1948 to 1965, our national income today would be 50 percent higher. The median income of the average family would be roughly $45,000 rather than the $30,000 it is today. I suspect we would then be hearing little debate over the loss of "good jobs."

The 1989 Economic Report nevertheless paints a highly optimistic picture for the years ahead. As table 3 of my prepared statement shows, it shows a future productivity growth rate of 1.9 percent, above the 1.4 percent which we had in this decade, and far above the 0.6 percent we had from 1973 to 1979. The report gives several reasons why an increase in productivity growth will come about.

You should be aware, however, that CBO and at least the authors in our study are not as sanguine. Given the difficulties that economists have had in explaining the post-1973 productivity slowdown, we find no basis for projecting an acceleration of productivity growth in the future. Moreover, the likelihood that oil prices will not decline appreciably in the years ahead should reverse one of the major factors the Economic Report claims to have enhanced the jump in productivity growth in the 1980's.

There are at least two reasons why Congress and the public should care about these seemingly academic differences in productivity growth protections.

First, these projections have dramatic effects on the forecasts of the Federal budget deficit. For example, by projecting that future productivity will grow faster by the seemingly small margin of 0.6 percent per year than the CBO forecast, the administration shaves $60 billion off CBO's $135 billion baseline deficit for fiscal 1993.

Second, if the administration's forecast of higher productivity growth proves correct, Americans will be able to avoid much of the pain associated with eliminating our twin deficits, the so-called trade and budget deficits over time. Table 4 of my prepared statement shows, for example, that under the assumptions in our study, with 2.5 percent GNP growth, policies that would reduce the U.S. balance of payments deficit to zero by 1995 would cut the per capita growth rate of consumption over the 1987–95 period to 0.7 percent per year, less than half of the 1.8 percent growth rate enjoyed between 1979 and 1987. But if GNP should advance at the administration's projected 3.2 percent rate, then America could balance its trade books and enjoy a per capita growth rate in consumption twice what we project.

Like most other economists outside the administration, I do not believe its future productivity growth projections are realistic. They seem to me to rest largely on faith. But however much we may quarrel about these projections, I think most economists can agree that the Government should take whatever steps it can to maximize the growth of productivity. Here are some key suggestions:

First, more saving and investment will clearly enhance productivity growth. From 1951 through 1980, this nation saved and invested on a net basis about 7.5 percent of its GNP. In this decade, net national savings has fallen to only 3 percent of GNP and net investment to about 5 percent. To sustain even the smaller fraction of investment, we have been forced to import goods and capital from abroad.

How can we do better? Well, the drop in our national savings rate is due equally to a drop in private and government savings. There unfortunately is little evidence that marginal changes in the Tax Code can affect private saving, but we understand the reason for the drop in government saving: it's the massive Federal deficit.

So I suggest that the best way we know how to increase total national saving is to steadily reduce the Federal budget deficit. Such reduction will also enhance investment. It is also no accident that the net investment share of GNP has fallen in the 1980's given real interest rates that have averaged over 5 percent in this decade in comparison to 2 percent between 1951 and 1980. Orderly elimination of the deficit would allow the Federal Reserve to lower interest rates and thus stimulate investment.

Deficit reduction would also have another little-recognized but very important productivity-enhancing effect. In my view, one of the reasons why productivity has grown much more rapidly in manufacturing in the 1980's than in services is that only the manufacturing sector has been subjected to stiff foreign competition. But if we fail to tackle the budget deficit problem, then the Federal Reserve will inevitably be forced to keep interest rates high to prevent inflation, and we see that happening right now.

But high interest rates will keep the dollar from falling, and thus will keep us from correcting our trade imbalance. And if that occurs, I fear that many in Congress will be intensifying their calls for protectionist devices, all in the name of fair trade, of course, which will only curtail incentives for our manufacturing firms to improve their productivity performance.

I will quickly conclude by just ticking off the other suggestions in my prepared statement. We need to increase the proportion of the Federal budget expenditures that are devoted to so-called investment outlets. This proportion has fallen, as the Economic Report of the President points out, from roughly 2 percent in the mid-1960's to little more than 1 percent today.

Next, most studies of productivity growth assign a very strong role to advances in knowledge, and we get those advances by research and development. But unlike other forms of investment, R&D has substantial externalities or public benefits that are not fully captured by those who make the investments, and so for this reason I favor the administration's proposal to make the R&D tax credit permanent.

Third, there is some tentative evidence that tying employee's compensation to the performance of their firms will enhance productivity. Brookings has launched a major project in this area under the direction of Alan Blinder of Princeton, and we will shortly be having some results which I would be happy to pass on to you when they are available.

Finally and perhaps most important, America's productivity challenge will only ultimately be met by the owners and managers of U.S. firms. In this regard I note two distressing recent tendencies.

One is for American companies to ignore important technological and commercial innovations that have been introduced in other countries. And, second, Americans have much to learn from the pricing-for-market share strategies that are followed by Japanese firms. These strategies permit their firms to exploit economies of scale and put the heat on both their managers and their workers to reduce costs in order to justify their lower prices.

Thank you for your patience and I will look forward to your questions.

[The prepared statement of Mr. Litan follows:]

PREPARED STATEMENT OF ROBERT E. LITAN[1]

Thank you, Mr. Chairman, for inviting me to provide comments on the 1989 Economic Report of the President and the long-term outlook for the American economy. Given the short time available, I am going to concentrate on only three of the many possible issues in which this Committee is interested: (1) the current health of the U.S. financial system, with special emphasis on the savings and loan crisis; (2) the effects of increased leverage in the corporate sector; and (3) the critical role of federal policy in influencing the growth of American living standards in the long run.

Health of the Financial System

From the end of World War II through 1979, the U.S. enjoyed a remarkable degree of stability among its financial institutions. Few failed each year and when they did, it was generally because of some kind of insider abuse.

The experience of the 1980's has been radically different. As shown in Figures 1 and 2, annual failures of both savings and loans and commercial banks have risen sharply. And the nation now faces a staggering bill for cleaning up thrift insolvencies in particular.

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[1] Senior Fellow and Director, Center for Economic Progress and Employment, Economic Studies Program of the Brookings Institution. The views expressed in this testimony are those of the author and do not necessarily reflect the views of other staff members, officers, or trustees of the Brookings Institution.

Although this Committee has no direct jurisdiction over legislation affecting depository institutions, your members and staff can play an important role in helping to educate Congress and the public as to how these problems arose; how to clean up the mess they have created; and how to prevent future crises. I would like to offer my own thoughts on each of these issues.

Causes -- One of the dangers in the current crisis environment is that the public and policymakers will draw the wrong lessons from past experience. In particular, I refer to the impression in some quarters that "deregulation" has caused the massive increase in bank and thrift insolvencies.

This view oversimplifies, and indeed mischaracterizes, the causes of the problem. In fact, two forms of deregulation this decade have clearly enhanced the safety of America's depository institutions.

Deposit interest deregulation in the early 1980's halted a potentially debilitating run by depositors into money market funds that were able to offer yields well above the 5.5% deposit interest ceilings.

Similarly, geographic deregulation -- or the gradual move toward nationwide interstate banking -- has also promoted financial stability by allowing depository organizations to diversify their risks. Unfortunately, many geographic restrictions remain. As shown in Table 1, of the 10 states that have recorded the most bank failures since 1982, only one

(California) has allowed its banks statewide branching rights. By limiting branching, the other states prevented their banks from diversifying in a decade when plummeting agricultural and energy prices brought down many local economies -- and their local banks with them.

In fairness, many critics of "deregulation" recognize these points, but point their fingers at so-called product-line deregulation -- or broader powers -- and inadequate supervision as the real villains in the thrift crisis. They are right to attack weak or lax supervision -- which should be distinguished from "regulation". Between 1980 and 1984, the numbers of thrift examiners were slashed (from 638 to 596) and not significantly replenished until the horses they were told to watch had already bolted from the barn. It is not surprising therefore to read new reports each day in the press about the "waste, fraud and abuse" among many failed thrifts. But let's not forget that bank regulators, too, also missed their share of imprudence and fraud in the 1980's.[2]

To many, the charge against broader thrift powers seems equally valid. In 1980 and 1982, Congress allowed federally chartered thrifts to expand into consumer and business lending. And certain states -- notably California and to a lesser extent, Florida and Texas -- have permitted their states to take equity interests in a wide range of assets and activities. Table 2 shows that, in fact, many more insolvent thrifts have

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2. The Comptroller of the Currency has recently reported that some form of insider abuse played a significant role in 35% of the banks declared insolvent by the Comptroller between 1979 and 1987. See Comptroller of the Currency, Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks (June 1988).

invested heavily in commercial mortgages and equity investments than their healthy competitors. In addition, thrifts in California, Texas and Florida -- where roughly half of all insolvent thrifts are currently operating -- have taken advantage of the new powers to a far greater extent than thrifts located elsewhere.

It is tempting to conclude that these patterns prove a causal relationship: that broader thrift powers led to more failures. Similarly, it may be convenient to blame much, if not all, all of the thrift mess on the unscrupulous and potentially illegal machinations of many thrift operators whom the Department of Justice will now be trying to put in jail.

But there are deeper economic reasons, in my view, for the thrift crisis that must be recognized if we are to prevent future disasters. In brief, we allowed people into the thrift industry with relatively little capital to then leverage their investments by 30 or 40 times by gathering federally insured funds and then to gamble those funds on high risk investments. And then when many went broke, we not only let them remain in business but we permitted them to double their bets -- and to more than double the FSLIC's loss.

Here's how it happened. Until 1985, anyone could enter the thrift industry with a capital contribution of only 3% of assets, compared to 6% for banks. Moreover, thrift capital contributions were computed under "regulatory accounting principles" ("RAP") that were (and still are) more lenient than the "generally accepted accounting principles" ("GAAP") required for banks. The loose capital requirements, combined with lax supervision, virtually invited new entrants into the industry to gamble, which many did by taking advantage of some of the new powers the states and the federal government had granted.

By 1985, many of these gambles had turned sour, especially in Texas, such that approximately 500 thrifts were insolvent under GAAP standards. Included in this undistinguished group were many thrifts that were also insolvent on a market value basis during the early 1980's when short-term interest rates soared into double digits (well above the yields thrifts were locked into earning on their mortgages). At this point -- say in 1985 -- had all GAAP-insolvent thrifts been closed or merged quickly, the cost to the FSLIC would have been about $20 billion.

But as in the "Fram" oil filter television advertisement that ran some years ago, our regulators, Executive branch, and yes, the Congress did not put up the money for what would have been analogous to an admittedly expensive oil change. Instead, policymakers opted to wait for a much more expensive engine overhaul -- one that will cost at least 5 times as much. Thus, regulators not only were forced by a lack of funds to keep most of the insolvents in operation, but they allowed, indeed even encouraged, these thrifts to "grow out" of their difficulties.[3] Between early 1985 and early 1988, deposits in insolvent thrifts soared from roughly $100 billion to $200 billion. With nothing to lose and everything to gain, the insolvent thrifts channelled the additional $100 billion into ever riskier investments to justify the higher interest rates they had to pay to attract depositors. It is as if Washington financed a group of bankrupt people to go to Las Vegas with $100 billion. Should we therefore now be surprised by the result?

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[3] A recent study by two economists at the Federal Home Loan Bank Board documents that more than 60 percent of the GAAP-insolvent thrifts open in June 1988 had been operating for at least two years; 35 percent had been in that condition for at least four years. See James R. Barth and Michael G. Bradley, "Thrift Deregulation and Federal Deposit Insurance", paper presented to a conference at the Federal Reserve Bank of Cleveland, June 1988.

In sum, virtually meaningless capital standards are the central villain in this story (backed by many regulatory and political accomplices), not broader thrift powers. As table 2 shows, healthy thrifts -- or those that are well-capitalized -- have not jumped massively into non-traditional investments. But for weakly capitalized or insolvent thrifts, the mixture of broader powers and insured funds was like putting a torch to a tank of gasoline.

Cleaning Up the Mess -- The immediate task now is to clean up the mess and we can thank the Administration for proposing a $50 billion rescue plan that would go a long way in this direction. Unlike the first two "trial balloon" proposals -- that would have put all of the rescue cost first on depositors and then on banks and thrifts -- the final plan spreads the pain. This not only makes the rescue more politically palatable, but for the most part eliminates the possibility that any sizeable amount of bank and thrift deposits will move to money market funds.

Still, the plan has its shortcomings. First, the $50 billion it asks for will probably not be enough. As I outline in Appendix A to this testimony, it will take nearly that much just to close the 350 GAAP-insolvent institutions now operating. Even more will be required to deal with many GAAP-solvent institutions that are nevertheless insolvent on a market value basis and are unlikely to meet the Administration's stiffer capital requirements, which I will discuss next. Recent increases in short-term interest rates threaten to make this problem worse.

Accordingly, there is a good chance that the Administration and Congress will have to revisit the funding issue when the $50 billion in bond issuing authority runs out in 1991 (the year before the next election) -- an assessment that is shared by the General Accounting Office, the Shadow Financial Regulatory Committee and other non-government observers. More importantly, 'erring on the cheap side' will again limit the bargaining power of the insurance agencies in their attempts to assist the sale of failed thrifts. One of the lessons to be learned from the Bank Board's massive sale of failed thrifts in late 1988 is that when the authorities have little or no money in the till -- and thus limited ability to liquidate institutions -- they will be tempted to accept merger proposals that require generous assistance and extended forbearance from capital requirements. The additional $50 billion will go a long way toward correcting this problem. But if, as I suspect, regulators eventually realize it is not enough, they will either practice capital forbearance yet again or be unwilling and unable to drive as hard a bargain as they could if they knew they had more resources available.

Second, given that the problem is growing every month, I believe it is a mistake to stretch out the borrowing over a three year period. We need the money now or as soon as possible. There is no reason why the FDIC and FSLIC cannot auction off or close all of the 350 GAAP-insolvent institutions in two years or less. If they say they can't, then give them more personnel or authority to contract it from outside.

Third, it is needlessly expensive to raise the money through a new off-budget agency, the Resolution Funding Corporation, rather than through Treasury bonds. Certain Administration officials have acknowledged that the additional interest cost will amount to $2 billion, a number I believe is reasonable (given interest rate spreads between Treasury bonds and those issued by the Farm Credit Association, whose bonds are comparable to those to be issued by the new RFC).

The Administration's reason for circumventing the Treasury, of course, is to keep the $50 billion in bond principal off budget and thus to ease its already Herculian task of meeting the Gramm-Rudman-Hollings deficit reduction targets. But why should society pay $2 billion for such games when other alternatives are available?

For example, Congress could allow the bonds to be issued by the Treasury but simply not record the principal on budget, which normally is reserved only for expenditures that have real macroeconomic effects. But as Thomas Woodward of the Congressional Research Service has recently explained in an excellent report,[4] the initial borrowing proposed by the rescue plan should have, at a first approximation, no macroeconomic effect. The $50 billion in additional credit demanded by the RFC would be immediately put back in the credit markets when the FDIC pays off insured depositors and assists new owners of failed thrifts. As a result, interest rates and net spending should remain undisturbed.[5]

Alternatively, the additional Treasury borrowings could be placed on budget, but the G-R-H targets revised upwards to offset their impact. Since the thrift losses have already occurred, it makes little sense to bring them onto the budget and then contract the economy by increasing the cuts in other spending programs beyond those required by the G-R-H schedule.

Preventing Another Crisis -- The Administration's rescue plan offers several reforms to help prevent another thrift crisis in the future. The proposal that has received the most attention -- combining the FSLIC and the FDIC and moving the Federal Home Loan Bank Board and System into the Treasury Department -- has its merits. But the far more important recommendation would require thrifts to meet bank capital standards by June 1991, even though it appears that over 1000 of the nation's 3000 thrifts cannot currently comply. Understandably, many of these thrifts will urge Congress to postpone, if not kill, the Administration's capital proposal. *I urge you in the strongest way I can to ignore these complaints, even if it costs more money to close additional institutions (Remember the "Fram" commercial)*. In my opinion, the Congressional reaction to the Admministration's capital proposal is the acid test of its willingness to prevent a future disaster.

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[4] G. Thomas Woodward, FSLIC, The Budget, and the Economy, Congressional Research Service, January 12, 1989.

[5] Of course, when the Treasury pays interest on these bonds -- and must borrow funds from the credit markets to do so -- this will have a macroeconomic impact. The interest payments provide additional income to the bondholders, some portion of which will be spent on goods and services, thus stimulating the economy. At the same time, additional borrowing for this purpose will place upward pressure on interest rates. The Administration's plan correctly proposes to include these interest payments on budget, although its recent budget document appears to hide the interest costs largely in a catch-all category labelled 'FSLIC disbursements'.

But here, too, more should be done. First, the plan proposes to give the capital standards some teeth by authorizing regulators to put weakly-capitalized, but still technically solvent, thrifts into receivership. This "early intervention" mechanism should be *mandatory* so that regulators have the statutory *responsibility* -- insulated from political pressure -- to step into institutions *before* they fall into insolvency. Moreover, I would hope the Congress can act quickly on the rescue plan to give regulators this responsibility. They will need it to keep many weakly capitalized thrifts that have little hope of meeting the tighter capital standards by 1991 in a conventional fashion (floating new stock and subsordinated debt and adding earnings to capital rather than paying them out as dividends) from taking "bet the bank" risks.

Second, regulators should move toward the use of *market value* accounting for both banks and thrifts. When insured institutions fail, the insurance agencies stand to lose the difference between their assets and liablities, measured at market value rather than historical cost (the basis for GAAP accounting). The Administration's plan says that Treasury will "study" market value accounting; it should do more than that by implementing it in a feasible form as rapidly as possible.[6]

Finally, the Administration's plan calls for Treasury to study the possibility of lowering the $100,000 deposit insurance ceiling. Indeed, the 1989 Economic Report implicitly suggests that no additional study is needed and recommends that the ceilings be lowered to encourage depositors to discipline risk-taking banks and thrifts.

Although this suggestion may be attractive in theory, I do not think it would be of much use in practice. If the insurance ceiling is dropped to some lower number -- say $50,000 -- then large depositors (acting alone or through brokers) will then simply break up their deposits among banks in smaller chunks: $45,000 per bank rather than the current $90,000-$95,000. More importantly, federal regulators have already made clear on a number of occasions this decade that they will protect uninsured creditors in large failing or failed institutions by arranging for their merger -- as in the case of American Savings & Loan of California and First RepublicBank of Texas -- or through government takeover, as in the case of Continental. As a result, uninsured depositors in large institutions today now understandably expect to be protected if their banks or thrifts should fail in the future. For this reason, changing the dollar value of the insurance ceiling would exert no disciplinary effect on the largest institutions, or those whose failure poses the greatest risks to the financial system. Policymakers should look instead to sound capital standards -- enforced through mandatory early intervention by regulators -- to prevent excessive risk-taking by insured depositories.

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[6] A common objection to the use of market value accounting is that many of the assets banks and thrifts hold are not readily tradeable. This objection can be met in at least two ways. First, non-traded assets (such as mortgages) can be valued at the price the market sets for analogous tradeable instruments (such as mortgage-backed securities). Second, accountants can at least measure the effect of interest rate changes on assets and liabilities through conventional discounting techniques (the present value of a 10 year $100 loan yielding a fixed interest rate of 10% drops when interest rates rise to 11%). Even with these "quasi-market value" adjustments, the books of thrifts and banks would provide a much more realistic indication of their financial health than current GAAP-based accounting measurements.

Rising Corporate Leverage

The trend toward increased leverage in the corporate sector -- demonstrated principally by the rising ratio of corporate interest payments to cash flow (or income) -- has been widely commented on, especially in light of some of the recent leveraged buyouts of major American corporations. Although the 1989 Economic Report makes no mention of this issue, it has been the subject of numerous Congressional hearings. For these reason, I offer several observations on the question today.

Increased leverage arouses concern primarily because of the fear that in the event of further sharp increases in interest rates and/or another recession, the U.S. could be hit by a wave of corporate bankruptcies.[7]

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7. Indeed, in a recent study published in the Brookings Papers on Economic Activity (BPEA), Professors Ben Bernanke and John Campbell of Princeton estimated that a rerun of the 1981-82 recession -- the worst

This could shatter business and consumer confidence and thus aggravate any economic downturn. Alternatively, as Benjamin Friedman of Harvard has argued, the Federal Reserve could be so worried about this outcome that it restrains its anti-inflationary zeal and follows a more expansive monetary policy than might otherwise be desired.

These are valid concerns. But there are also offsetting considerations. As shown in Figure 3, the sharp increase in business bankruptcies in the 1980's -- especially since the recession ended in 1982 -- demonstrates that the economy can grow at a healthy pace despite a rising trend of business failures. A major reason is that bankruptcy does not mean that a company is necessarily dismantled and its employees scattered to the winds. Instead, as the Texaco and Johns Manville bankruptcies amply demonstrate, life can go on and employees continue to work while a bankruptcy judge supervises the restructuring of the rights of shareholders and creditors. More often, the required reorganization takes place outside formal bankruptcy proceedings.

Still, these are no reasons to be complacent. The fact is that neither economists nor anyone else know how consumer and business confidence would be affected during the next recession if the corporate bankruptcy rate were to increase sharply. For this reason, policymakers

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of the post-War era -- could bankrupt 10% of America's corporations. See Ben S. Bernanke and John Y. Campbell, "Is There A Corporate Debt Crisis", BPEA, 1988:1, pp. 83-125.

should ensure that government does not actually provide incentives for corporate managers to take on debt.

Unfortunately, such incentives have long been in place in the income tax code, which permits corporations to deduct interest, but not dividends, in calculating their taxable incomes. There is now widespread recognition that this bias toward debt must be corrected, namely that the tax code should treat dividends and interest in a neutral fashion. At the same time, because of the current budget deficit, there is also a consensus that any correction of the corporate tax code must also be "revenue neutral".

Consensus breaks down, however, over the proper solution. Several recently have surfaced:

1. One approach is to change the corporate income tax to a cash flow tax. Cash flow would be defined as net revenue minus net investment expenditures (gross investment minus asset sales). By deducting investment fully in the first year, but neither dividends nor interest, the cash flow tax would presumably encourage investment while treating both debt and equity in a neutral fashion.[8]

2. The corporate income tax can be retained but nevertheless altered to put debt and equity on a level playing field:

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[8] Glenn Hubbard of Columbia University has recently suggested that a revenue-neutral switch to a cash flow tax would allow a lower rate of corporate taxation. See Wall Street Journal, February 16, 1989, p. A14.

a. Corporations could be allowed a single charge for the 'cost of capital', which would not depend on the debt-equity mix.

b. Both interest and dividends can be made fully deductible and the corporate tax rate increased to offset the revenue loss from dividend deductability.

c. The code could deny deductability for both dividends and interest and then allow the corporate tax rate to drop to offset the revenue gain from from disallowing interest deductions.

3. Finally, if wholesale corporate tax reform is deemed too radical, some have suggested incremental steps such as introducing partial deductability of dividends with an offsetting partial disallowance of interest deductability.

Each of these proposals has its advocates and detracters. But Congress appears reluctant to take firm action on this issue -- and wisely so -- until there is greater understanding of how each would affect the economy. In particular, implementing each of the alternatives raises significant transition issues and each would affect various industries quite differently.

Accordingly, I suggest that the Congress commission a study -- perhaps by the Congressional Budget Office or by some outside experts -- to 'run a horse race' to compare all of the various plans for ridding the corporate tax system of its bias toward debt in a revenue-neutral fashion. Such a study should be completed in a relatively short time frame to be useful to the current debate and should compare the proposals on at least the following dimensions: their effects on different industries, aggregate investment, new business formation, and innovation, and any distortions they might introduce into private sector decision-making.

Improving American Living Standards

Finally, the most important long-run economic challenge for policymakers is to help ensure that government policies maximize the growth in living standards for all Americans. The key to improving living standards is rising productivity. Only by increasing the output each worker produces will we be able to give our workers higher real incomes.

As this Committee is well aware, productivity growth in recent decades has been disappointing and the consequences have been dramatic. As Martin Baily and Margaret Blair point out in a recent Brookings study,[9] if private sector productivity had grown since 1966 at the 3.2% rate at which it had advanced from 1948 through 1965, our national income today would be 50% higher. The median family income would be roughly $45,000 rather than the $30,000 it is today. I suspect we would be hearing little debate over the loss of "good jobs".

What lies ahead? The 1989 Economic Report paints a highly optimistic picture. As shown in Table 3, it projects annual growth in non-farm productivity to accelerate to 1.9% -- substantially above the 1.4% rate experienced much of this decade, and more than triple the disappointing 0.6% rate experienced in much of the 1970's. The authors of the Report believe productivity growth will return to its 1948-81 average primarily because labor force growth will slow (permitting a more rapid increase in the capital-labor ratio) and baby boom workers will mature (and thus bring greater experience to their jobs).

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[9] "Productivity and American Management", in Robert E. Litan, Robert Z. Lawrence, Charles L. Schultze, eds., American Livings Standards: Threat And Challenges (The Brookings Institution, 1988), pp. 178-214.

The Congressional Budget Office (CBO) and the authors in a recent Brookings study of living standards are not as sanguine (Table 3).[10] Given the difficulties economists have had in explaining the post-1973 productivity slowdown, these studies see no basis for projecting an acceleration of productivity growth in the future. Moreover, one of the factors the 1989 Report claims to have pushed productivity growth up in the 1980's -- the dramatic drop in the price of oil and other energy sources -- is unlikely to be present in the 1990's. With this source of additional productivity growth removed, future productivity growth could actually be lower than in the 1980's.

There are at least two reasons why Congress and the public should care about these seemingly academic differences in productivity growth projections. First, they can have dramatic effects on forecasts of the federal budget deficit, and thus on the need for corrective policy actions by the Congress and the Administration. Most of the difference between the Administration's projection of 3.2% annual growth in real GNP between 1988 and 1994 and the CBO's lower 2.3% projection is due to the difference in productivity growth projections.[11] For example, by projecting that future productivity will grow faster by the seemingly small margin of 0.6% per year, the Administration shaves $60 billion off the $135 billion CBO baseline deficit for FY 1993.[12]

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[10] See Analysis of President Reagan's Budgetary Proposals for Fiscal Year 1990 (CBO, February 1989); and Litan, et al., American Living Standards: Threats and Challenges.

Similarly, if the Administration's forecast of higher productivity growth proves correct, Americans will be able to avoid much of the pain associated with eliminating our twin deficits -- the trade and budget deficits -- over time. As shown in Table 4, we calculated in our recent Brookings study that with 2.5% GNP growth, policies that would reduce the U.S. balance of payments deficit to 0 by 1995 would cut the growth rate of per capita consumption (private and government) over the 1987-95 period to 0.7% per year, less than half of the 1.8% growth rate enjoyed between 1979 and 1987. But if GNP should advance at the Administration's projected 3.2% rate, then America could balance its trade books and enjoy a per capita growth rate in consumption (1.4%) twice what we project.

Like most other economists outside the Administration, I do not believe its future productivity growth projections are realistic. They seem to me to rest largely on faith.

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[11] The rest is due to the Administration's projection that unemployment can fall to 5.0% without igniting an acceleration in inflation; CBO projects that unemployment level to be 5.5%.

[12] CBO reports that a 1.0 percentage point increase in the GNP growth rate -- over the 2.3% assumption used in its budget projections -- would reduce the FY 1993 budget deficit by $101 billion. As a result, GNP growth 0.6 percentage points above the CBO assumption would reduce the deficit in that year by $60 billion. See The Economic and Budget Outlook: Fiscal Years 1990-94 (CBO, January 1989), p. 51.

But however much economists may quarrel about the likely future course of productivity growth, they can at least all agree that the government should take whatever steps it can to maximize that growth. I will conclude by pointing to several growth-promoting actions that I believe are most important.

First, although they may argue by how much difference it will make, all economists can tell you that more saving and investment will enhance labor productivity growth. As I am sure this Committee is aware, the savings and investment performance of the U.S. in the 1980's has been highly disappointing. From 1951 through 1980, this nation saved and invested on a net basis (that is, after depreciation) approximately 7.5% of its GNP each year. In the 1980's, however, net national saving has averaged only 3% of GNP; net investment about 5%. To sustain even the smaller fraction of investment -- one that is lower than in all other industrialized nations except the United Kingdom -- we have been forced to import goods and capital from abroad.

How can we do better? The drop in our national savings rate is due equally to a drop in private and government savings. There is little evidence that marginal changes in the tax code affect private saving; indeed, the private saving rate has fallen in this decade despite the Reagan-era tax incentives that were supposed to increase it. But there is no doubt about the reason for the drop in government savings: it is the explosive increase in the federal budget deficit. Accordingly, whereas we lack confidence about what the governmet can do to increase private saving, we know that a steady reduction of the federal deficit will reduce government dissaving and thus enhance national saving.

Budget deficit reduction will also enhance investment. It is no accident that the net investment share of GNP has fallen in the 1980's given real interest rates this decade averaging 5% or more -- over twice the 2% average during the 1951-80 period.[13] Orderly elimination of the current federal deficit would allow the Federal Reserve to loosen its monetary policy and thus permit interest rates to drop -- by at least 1.5 percentage points -- and thus help stimulate investment.[14]

Budget deficit reduction would have another important, but little-recognized, productivity-enhancing effect: it would help blunt otherwise rising pressures for protectionist trade policies here and abroad. Let me explain.

Many commentators, including the authors of the 1989 Report, have noted with some satisfaction the strong recovery of annual productivity growth in U.S. manufacturing in the 1980's to over 3% compared with 1.4% growth between 1973 and 1979. Although the Bureau of Economic Analysis is expected shortly to lower the magnitude of this estimated rebound,[15] there is no escaping the fact that America's manufacturing sector has turned in a far more impressive productivity performance in this decade than our service sector, which has displayed virtually no productivity growth at all. I believe a major reason for the greater success in manufacturing is that firms in this sector have been exposed to intense foreign competition which has forced American companies to improve productivity or die.

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[13] Domestic investment would have fallen even more had foreigners not been so willing to lend us the money.

[14] American Living Standards, p. 106. Eventually, it will desirable for the federal (unified) budget to move into surplus in order to generate the additional savings and investment that will make it easier for next generation to finance the retirement of the baby boom generation. On this subject, see Henry J. Aaron, Barry P. Bosworth and Gary Burtless, Can America Afford to Grow Old? (Brookings, 1989).

Failure to bring the federal budget deficit down significantly will increase pressures for protection and thus diminish the productivity-enhancing benefits of foreign competition. Although the substantial depreciation of the dollar since 1985 has brought us some improvement in the trade balance, most economic analyses I have seen project little further reduction in the trade deficit at current dollar exchange rates. Now that our economy is so near full employment, we cannot afford to let further dollar depreciation by itself cure our trade deficit. Without contracting domestic demand by lowering our federal budget deficit, a lower dollar will encourage greater demand for our exports, and thus threaten to overheat our economy.

Unfortunately, this same reasoning suggests that if we fail to correct the budget imbalance, the Federal Reserve will be forced to keep interest rates high to prevent inflation. But high interest rates will keep the dollar from falling and thus will keep us from correcting our trade imbalance. And if that occurs, I fear that eventually many in Congress will be intensifying their calls for protectionist devices -- all in the name of "fair trade" of course -- which will only curtail incentives for our manufacturing firms to improve their productivity performance.

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[15] See Lawrence Mishel, "The Late Great Debate on Deindustrialization", Challenge, Jan/Feb 1989, pp. 35-43. Even without the impending corrections, U.S. manufacturing productivity growth since 1979 has lagged behind that of the United Kingdom, Italy and Japan.

Second, the federal government itself can pay more important to investment issues in its budget. The 1989 Report notes that since the mid-1960's the share of our GNP represented by federal non-defense investment outlays -- for infrastructure and research and development (R&D) -- has steadily declined (from a peak of about 2% to little more than 1% today). In cutting the deficit, therefore, Congress would wise not to scrimp on these investment expenditures; and when we do come closer to budget balance, these investment outlays should be increased.

Third, most studies of productivity growth assign a major role to advances in knowledge, which come about through research and development (R&D). Unlike other forms of investment, R&D has substantial "externalities" or public benefits that are not fully captured by those who make the investments. For this reason, I believe the Congress should look with favor on the Administration's proposal to make the R&D tax credit permanent (despite its modest impact on the deficit, an average of about $1 billion per year over the next 5 years).

Fourth, there is some tentative evidence that tying employees' compensation to the performance of their firms -- whether through profit-sharing or stock ownership plans -- enhances productivity. Brookings has launched a major project on this issue under the direction of Alan Blinder of Princeton and we will be holding a conference on the draft papers next month. We will be happy to make the findings from this project available to your Committee as soon as they are available.

Finally, and most important, America's productivity challenge must ultimately met by the owners and managers of U.S. firms. I offer no special wisdom on this subject, except two points that Blair and Baily offer in Brookings' recent project on living standards. First, there is a distressing tendency for American companies to ignore important technological and commercial innovations introduced in other countries. In particular, several months ago I noticed a report in the press that few U.S. firms took advantage of a service that made descriptions of Japanese patents and technological advances available in English. Second, American firms have much to learn from the "pricing for market share" strategies followed by Japanese firms. Such pricing strategies allow firms to exploit economies of scale. They also force workers and managers to find the cost reductions that are necessary to turn those low prices into high profits.

Appendix A

Estimating The Cost of Solving the Thrift Crisis[16]

Until the job is completed, no one can know how much it will cost to clean up insolvencies in the thrift industry. The Administration estimates the ultimate cost to be $90 billion -- roughly $40 billion for guarantees, notes and cash extended to new owners of failed thrifts in 1988 and another $50 billion to handle 350 currently operating GAAP-insolvent thrifts and any future thrift insolvencies over the next three years. The FDIC and the GAO have indicated that the costs may go even higher, as have a variety of outside experts.

The Administration has requested only $50 billion in additional bonds, however, because it believes that future FSLIC premium revenues, coupled with other funds the agency has or will have available, will cover the $40 billion in guarantees extended in 1988.

Although questions have been raised about the realism of the $40 billion cost estimate, I assume for this purpose that the estimate is reasonably accurate. But I doubt the realism of the Administration's projection that it will have sufficient funds from the sources it cites to cover the $40 billion cost. The principal reason is that the Administration's projection must assume steady, continued growth in deposits held in thrifts. But this is questionable given the

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[16] This Appendix draws on R. Dan Brumbaugh, Jr. and Robert E. Litan, "The S&L Crisis: How To Get Out and Stay Out", The Brookings Review, Spring 1989 (forthcoming).

Administration's insistence that the thrift industry meet bank capital standards by June 1991, a sound objective, but one that may force the regulators to liquidate or assist the merger of hundreds of additional thrifts (beyond those currently insolvent under GAAP standards). If this occurs, it is likely that some portion of the funds paid out to depositors will not be redeposited in other thrifts, but rather, in commercial banks or other investments. This will lower the deposit base on which FSLIC premium revenues depend and thus reduce the funds otherwise asssumed to be available to cover the $40 billion for 1988 notes and guarantees.

The $50 billion cost estimate for current and future thrift insolvencies over the next three years also looks low. At year end 1988, there were 350 GAAP-insolvent thrifts with combined assets of about $100 billion. In 1986 and 1987, the FSLIC lost 32 cents on every dollar of assets held by institutions that were merged or liquidated. On that basis, it will eventually cost $32 billion to clean up these 350 institutions. In the first 8 months of 1988, however, the FSLIC's loss experience doubled to 65 cents on the dollar, which if duplicated in the future, would push the cost of resolving the 350 thrifts to $65 billion.

The Administration argues that because the Bank Board liquidated or merged the "worst cases" in 1988, the future loss experience should be lower. This may be true, but because the Administration's rescue plan provides funds over a three year period, there will still be ample opportunity for many of the 350 currently insolvent thrifts to continue losing money -- even if they are brought under the supervision of the

FDIC. This is because most of these thrifts are locked into paying high interest rates on much of their deposit base for at least several years while being stuck with many non-yielding assets (loans in default or foreclosed property providing little or no revenue). As a result, the losses for many of the 350 will continue to mount.

Under these conditions, it is not unreasonable to assume that the FDIC/FSLIC will lose an average of at least 40 cents on the dollar on the thrifts in this group -- putting the cleanup cost at least at $40 billion. At the same time, because the $50 billion in bond proceeds are not being brought in immediately, but over a three year period, the present value of the additional revenue is closer to $45 billion. In short, the bond proceeds should just barely cover the cost of cleaning up the 350 currently GAAP-insolvents -- if the Administration is lucky.

But as I note in the body of the testimony, there are many hundreds of GAAP-solvent thrifts now operating that are actually insolvent on a market value basis.[17] Very few of these are likely to be able to meet the tougher capital requirements by 1991 and thus most in this group will require FDIC/FSLIC merger assistance or liquidation expenditures during the three year period covered by the $50 billion bond issue.

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17. The Shadow Financial Regulatory Committee believes there are at least 800 thrifts in this category. A more conservative estimate is 400, or approximately the number of thrifts that as of the third quarter of 1988 had GAAP capital-to-asset ratios of between 0 and 3% (capital levels this low in the thrift industry indicate a high likelihood of market value insolvency).

At a minimum, it is likely that another $200 billion in assets are held by GAAP-solvent, but market-value insolvent, institutions. Thus, even if the FSLIC experiences losses of only 10 cents on the dollar for the thrifts in this category, the total cost of cleaning them up would be $20 billion -- or easily enough to more than exhaust what little may remain of the $50 billion after the 350 GAAP-insolvents are removed from the system. And even the $20 billion estimate is likely to be conservative, since the assets involved may exceed $200 billion and the loss experience very likely would exceed 10 cents on the dollar.

Table 1

Distribution of Bank Failures

1982-88

		Number
1.	Texas	217
2.	Oklahoma	92
3.	Kansas	49
4.	California*	39
5.	Colorado	39
6.	Iowa	38
7.	Louisiana	34
8.	Minnesota	34
9.	Tennessee	33
10.	Nebraska	32
	Sub-Total	607
	All Other States	204
	Total of all Failures	811

*Allows statewide branching.

Source: American Banker, January 5, 1989, p. 9.

Table 2

Percentage of Thrifts Whose Holdings in Non-Traditional Investments Exceed 10% of Their Assets

June 1988

	Commercial Mortgages	Junk Bonds	"Equity At Risk" Investments
All Thrifts	37.7	0.3	3.2
GAAP[1] Solvent Thrifts	33.4	0.3	1.7
GAAP Insolvent Thrifts	59.9	0	11.5
Federal Thrifts	35.7	0	1.5
State Thrifts	40.4	0.8	5.5
California Thrifts	66.5	2.5	10.5
Florida Thrifts	58.2	1.4	6.2
Texas Thrifts	72.3	0.4	17.0

1/ "GAAP" refers to generally accepted accounting principles.

Source: James R. Barth and Michael G. Bradley, "Thrift Deregulation and Federal Deposit Insurance," paper presented to a conference at the Federal Reserve Bank of Cleveland, June 1988.

Table 3

Productivity and GNP Growth Rates

	Non-Farm Productivity	Real GNP
Economic Report of the President		
1948:4 - 1981:3	1.9	3.3
1973:4 - 1981:3	0.6	2.2
1981:3 - 1988:3	1.4	3.0
1988:3 - 1994:4	1.9	3.2
Congressional Budget Office 1/		
Post-1988	1.3	2.3
American Living Standards 2/		
1988-1995	1.2	2.5

1/The Economic and Budget Outlook: Fiscal Years 1990-94 (CBO, January 1989), and An Analysis of President Reagan's Budgetary Proposals for Fiscal Year 1990, (CBO, February 1989).

2/Litan, et al., American Living Standards: Threats and Challenges (Brookings, 1988).

Table 4

Historical and Projected Growth Rates of National Output and Spending

Percent a Year

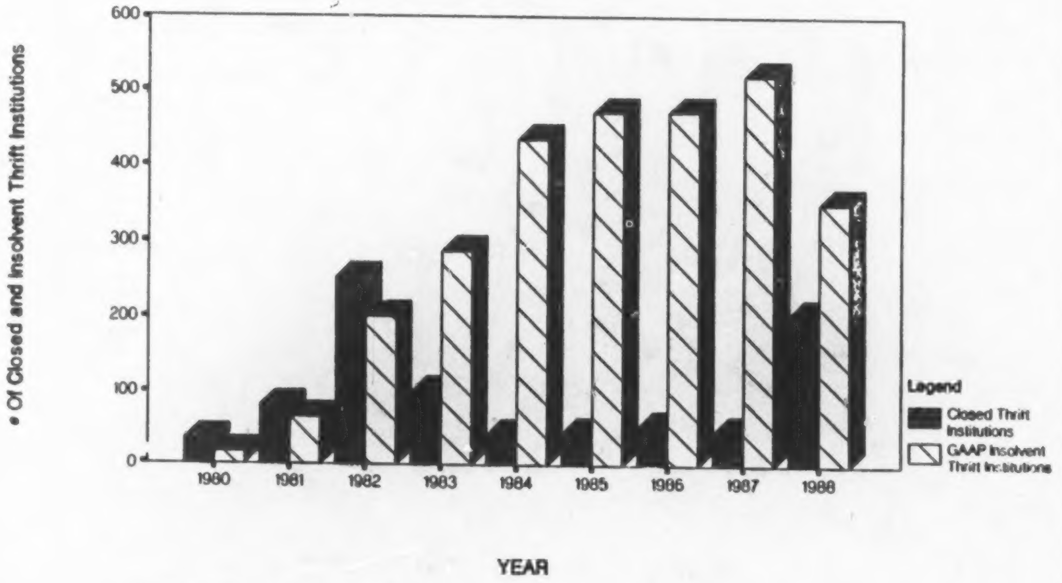
Period	Output per capita	Government and consumer purchases per capita
Historical		
1950-73	2.1	2.1
1973-79	1.2	1.2
1979-87	1.2	1.8
Projected*		
1987-95	1.7	0.7

*Assumes annual GNP growth of 2.5%.

Source: Litan, et al., American Living Standards: Threats and Challenges, P. 8.

FIGURE 1
Thrift Insolvencies and Closures

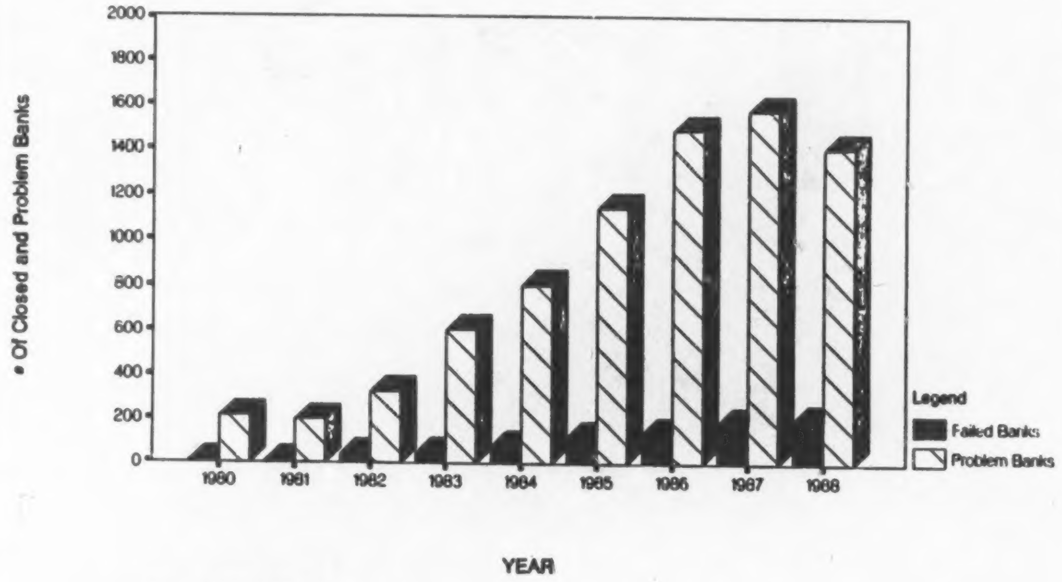
1980 - 1988



Source: The Federal Home Loan Bank Board
Note: Insolvency is Measured by GAAP. Closures Include Mergers

FIGURE 2
Failed and Problem Banks

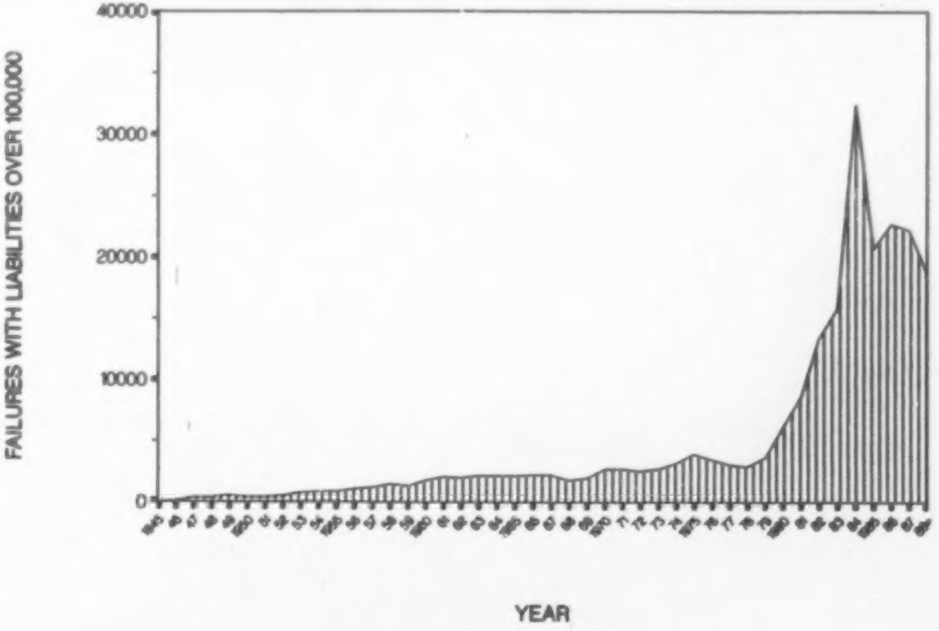
1980 - 1988



Source: FDIC Annual Reports, Various Years
and Unpublished data Supplied by the FDIC

FIGURE 3

Number of Business Failures: Institutions With Liabilties Equal to or Greater Than $100,000. 1945 - 1988



Source: Economic Report of the President, January 1989, Table b-95.
* Number of Failures 1988 was estimated with data through Nov 1988

Representative OBEY. Mr. Friedman, please proceed.

STATEMENT OF BENJAMIN M. FRIEDMAN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. FRIEDMAN. Thank you, Mr. Chairman. I am grateful for the opportunity to come before this distinguished committee to address the issues raised in the Economic Report of the President, and also to talk about other aspects of the economic problems that our country now faces.

I have submitted a prepared statement for the record and, If I may, I will briefly summarize it, rather than read through the whole prepared statement.

I chose to focus my remarks on the one economic problem that I think is of greatest consequence for the longrun economic prospects of the United States. That is the fact that the Federal Government's budget deficit, the borrowing that the Government regularly has to do to finance the excess of its spending over its revenues, has been absorbing about three-fourths of the net saving that American businesses and American families together have done in the 1980's.

That is a problem that has two very important consequences. The first is that, because this saving is being absorbed to finance the Federal deficit, it is not then available to finance investment in business equipment, machinery, plant, research, and all of the activities that the business sector could otherwise undertake in order to enhance its productivity and competitiveness.

It therefore is no accident that, as our share of national income devoted to net investment has declined rather than risen in the 1980's, and also as even the share of our national income devoted to gross investment—that is, investment inclusive of depreciation—has also been declining since 1981, we have had a very disappointing productivity performance in our economy except for very narrow spheres of activity. It is also no accident that we have had no growth, indeed some slight decline, in the real wage of the average American worker.

Especially during the election campaign last fall, we repeatedly heard that we are now in the midst of the longest running business expansion in U.S. peacetime experience. That is true. What we didn't hear, however, is that this is also the first expansion in 50 years in which the average American worker has seen his or her wage go up less rapidly than inflation. In 1983, the first year of the business expansion, the average American worker earned $281 a week. That wage is lower today, not higher, in 1983 dollars.

Representative OBEY. Excuse me. Would you say that again? I don't think I heard it accurately.

Mr. FRIEDMAN. In 1983, the first year of the business expansion, the average American worker in the business sector earned $281 a week. Today, priced in 1983 dollars, that wage is $270-some-odd. So, despite 7 years of supposed prosperity, the average worker is less well off, in terms of real wages, than he or she was when the expansion began.

The second problem is that, in addition to the deficit's eating away at our ability to maintain productivity growth and therefore an increase in our domestic standard of living, we are becoming ever more dependent on the kindness of strangers. Both Bill Niskanen and Bob Litan mentioned the fact that we have been running a huge trade imbalance. We have to finance that imbalance. Foreigners do not contribute to us, as if we were a charitable institution, all those cars and watches and cameras and computers; they sell them to us. And when we can't finance those purchases by what we sell abroad—something we have manifestly not been able to do in the 1980's—we then have to borrow from abroad.

We have done so in the 1980's on a scale that dwarfs anything in our prior experience. Bill Niskanen referred to the fact that, throughout our experience as a developing country, we always borrowed from abroad. That's true. That's what developing countries always do, to finance their investment. But now we are borrowing from abroad on a scale that, compared to our economic size, is larger than what we did at any point in our experience as a developing country, larger even than our peak period of international borrowing in the post-Civil War days. The main difference is that, instead of borrowing to put in place new railroads and the beginnings of our manufacturing industry and a new steel industry, as we did at that time, we are now borrowing to finance a flood of VCR's, cameras, and watches.

As a result, we are now no longer the world's largest lending country, providing our investment capital abroad and enjoying the particular role in world affairs that the world's leading provider of investment capital always plays. We are instead a borrowing country, dependent on other countries whose central banks hold dollars, and whose ministries of finance instruct their life insurance companies to support our Treasury bond auctions.

We are already seeing some erosion, albeit limited to date, in our ability to be effective in areas like trade negotiations with other countries. It's difficult to have a negotiation with another country in which we have to start by explaining how grateful we are to that country for having its central bank prop up our currency, and then proceed to complain that the other country bars your manufacturing products. That's a tough transition, even for the most skilled negotiators.

In these two senses, therefore, one the erosion of our ability to achieve sustained increases in living standards at home and, second, our increasing obligation as a nation to foreigners, we are pursuing a policy that has already had some serious consequences. In the long run, which Congressman Hamilton's letter of invitation emphasized, this problem will have even more serious consequences.

Now, in the spirit of what Bill Niskanen did a few moments ago, let me focus on a few misconceptions that have plagued the public discussion of this important subject.

First, some people have pointed out that other countries, which have not had these economic problems, have larger Federal deficits than we do compared to their national incomes. The typical example to which to point is usually Japan. It is true, of course, that Japan has a larger government deficit compared to its national income than we do compared to ours. But the difference is that Japan is a high-saving country, and we have always been a low-saving country. If we saved the share of our national income that Japan saves, then we too could afford to have that size government deficit and also invest what the Japanese invest.

But we have always been a low-saving country. Before the 1980's, at least the bulk of what we saved was available for investment. The difference in the 1980's is that now the bulk of what we save is siphoned off by the need to finance the Federal Treasury.

A second misconception is that we are using the deficit to support productivity-enhancing investment, and therefore that the Government is doing no more than what any sound business does when it turns to external finance to support installations of new capital. As Bob Litan just pointed out, that's simply wrong.

Ironically, from the perspective of people who offer this justification for our deficit, just as we are running the largest deficits in U.S. history, the share of our Government spending devoted to what might even generously be construed as productivity-enhancing investment has fallen to a record low. Financing roads, bridges, highways, port facilities, and research installations is not the right way to think about this deficit. If we were actually doing that, then we could have an interesting discussion about whether that kind of infrastructure investment might be just as valuable or maybe even more valuable, for enhancing our productivity, than business machinery and equipment. But since we are not doing that, such a discussion is strictly academic. The short of it is that we are not investing in any of the makings of a strong economy.

A third misconception, and one on which I am going to focus in the bulk of my subsequent remarks, is that the deficit has already declined substantially, and will continue to do so, with only minor modifications of our current fiscal policy strategy. It think that is wrong, and for a variety of reasons.

The bulk of the improvement in the deficit that we have seen in recent years has been due to a combination of the economy's returning to full employment, so that the actual deficit has shrunk but the structural deficit hasn't, and the use of the growing surplus in the Social Security account to mask a growing deficit in the rest of what the Government does.

During the election campaign, we repeatedly heard that the deficit declined from $221 billion in the fiscal year 1985 to only—and I put "only" in quotation marks—$155 billion last year. What nobody mentioned was that that $155 billion deficit last year was the combination of a $41 billion surplus in the Social Security account and $196 billion of deficit elsewhere. If we compare that $196 billion to the $221 several years before, and also allow for the fact that we have moved closer to, if not all the way to, full employment, we see that there has been little if any genuine improvement.

Finally, the fourth misconception I want to address—and this is one on which I think Bill Niskanen was particularly insightful—is that, just because the deficit has not delivered some cataclysmic, highly visible, tangible blowout, and indeed is not likely to do so, therefore it is not a problem at all.

I suspect that, from your perspective as the principals in our political system, the greatest single difficulty in dealing with the deficit problem is precisely the slow, gradual, subtle, corrosive nature of the damage that the deficit is doing in our economy. If instead there were a big blowout, with tangible, visible effects that everybody could see on the nightly news, you gentlemen and your colleagues would probably have dealt with this problem long ago. The difficulty is that there are no such effects. Therefore, the issue with which you must grapple—and I am not minimizing the difficlty of doing so—is that this is a corrosive, ongoing process without tangible, visible consequences in the short run. Yet that does not make it less damaging to our economy.

I went to conclude by addressing the question of whether the President's proposed plan for solving the deficit problem, namely a flexible freeze, so called, on Federal spending, together with no increase in revenues, will solve this problem. I believe it will not.

I believe it will not for a variety of reasons. One reason, as I mentioned before, is the Social Security surplus. When Mr. Bush reports a deficit—on his assumptions, and with his proposals—of $91 billion for fiscal year 1990, what that actually means is nearly a $160 billion deficit, using $60-odd billion of Social Security surplus to mask the general account deficit. That is only solving one problem by unsolving another. If we continue to use the Social Security surplus merely to offset enlarged dissaving by the Federal Government, we will not have done what we thought we were doing in 1983—namely, putting in place additional national saving, through the Social Security trust fund, in order to prepare for the retirement of the baby-boom generation.

A second reason for believing that Mr. Bush's proposals are unlikely to have the effect advertised is simply the administration's set of economic assumptions. Bob Litan has already focused on those assumptions. I would simply like to point out one further feature of these assumptions that he didn't mention in his remarks; namely, the contrast between the assumption of a sharp acceleration in economic growth together with a steep decline in market interest rates. Even if the forecasted growth is forthcoming, which I doubt, so that therefore the revenue side of the administration's projections is satisfied, it is highly dubious that in that case we would have a full 3 percentage point decline in market interest rates within the next year or so. Hence the interest expense projections will not be satisfied.

Finally, I think there is an inherent unworkability about the flexible freeze concept. I can give a couple of examples to indicate what I mean.

The flexible freeze supposedly calls for all non-Social Security spending to grow at no more than the rate of inflation. To pick up on Bob Litan's remarks, suppose, for example, that as 1990 goes along we have to spend more than we thought we would have to spend to close insolvent savings and loan institutions. Suppose this additional spending has a direct budget impact. What are we then to do? Are we, two-thirds of the way through the fiscal year, somehow to find additional spending cuts, in order to balance the additional spending that we have had to do, so that the total fits within the flexible freeze?

Suppose Medicare expenses overrun the projection that is in the budget, and we discover that problem halfway through the fiscal year. Are we then supposed, after the fact, to cut more Federal spending in order to keep the non-Social Security total within the flexible freeze?

Suppose interest payments overrun the administration's very optomistic projection. On some accounts of the flexible freeze, interest payments are excluded; on some they are included. If they are excluded, then whether the flexible freeze will work at all is heavily dependent on a dubious set of projections. If they are included, then, if interest rates turn out to be higher than the 5½ percent that the administration is predicting for Treasury bills, do we, halfway through the fiscal year, somehow ferret out yet new spending cuts?

My guess is that, when this committee meets in February of 1993, and the issue on the table is whether or not the flexible freeze worked in solving the budget problem, the answer will be that it didn't work because it was never tried. But the reason why it will never have been tried is that there is an inherent unworkability about the idea, as proposed, in the first place.

In summary, I believe that we do have a very serious problem. The Federal Government is absorbing our saving in a way that has never before taken place in the United States in peacetime, and that is already leading to economic consequences of a form that are highly predictable and are likely to continue unless we solve the problem. Unfortunately, I do not believe, that the budget proposals put on the table by the Bush administration adequately address the problem.

Mr. Chairman, thank you for allowing me to come before the committee.

[The prepared statement of Mr. Friedman follows:]

PREPARED STATEMENT OF BENJAMIN M. FRIEDMAN

Mr. Chairman:

I am grateful for the opportunity to present my views to this committee as it assesses the recent progress of the American economy, and focuses on the problem areas that now require urgent public policy attention.

America now has a critical economic problem. The federal government's fiscal imbalance is sapping our ability to be productive at home and to compete abroad. This corrosion is already stunting the growth of our standard of living. It is also already compromising our influence in world economic affairs. If left unchecked, it will continue to do both.

The heart of the problem is that, on average during the Reagan years, the government's borrowing to cover its budget deficit has absorbed three-fourths of the net saving done by all individual Americans and all American businesses combined. With so little of our private saving left over for private use, we have devoted barely two cents out of every dollar of our national income to net investment in business plant and equipment -- less than in the 1950s or the 1960s or the 1970s. As a result, productivity gains have been disappointing

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This testimony draws in part on my recent research and writings, including especially Day of Reckoning: The Consequences of American Economic Policy Under Reagan and After (Random House, 1988).

(apart from the usual all-too-brief cyclical surge just after the 1981-82 recession ended). And without productivity growth, business cannot pay higher real wages. As by now we have so often heard, the current economic expansion is already the longest in U.S. peacetime experience. But it is also the first economic expansion in fifty years in which the average working American's wage has gone not up but down compared to inflation.

Fixing the problem -- not in the sense of cancelling our accumulated debts, which is impossible, but of at least stopping the hemorrhage by freeing up America's private saving to be available once again to finance private investment -- will require making some hard choices. Those choices will be the more difficult because of the widespread perception of economic prosperity. But our country's prosperity today is actually a false prosperity, an illusion built on borrowing from the future. When President Reagan took office our federal debt (not counting what the government owes to itself) was $738 billion, or 26 cents for every dollar that the country produced and earned. The United States was also the world's leading creditor nation, with the power and influence that that privileged position has historically carried with it. But eight years of a radical new fiscal policy -- all years of peacetime -- have nearly trebled federal indebtedness, while the national income not even doubled. The net federal debt is now approximately $2.1 trillion, or 43 cents for every dollar of our income.

Worse yet, after seven years of reckless borrowing the United States is now the world's largest debtor nation, ever more dependent on the good will of the countries that lend the money to keep the party going. It is surrendering the ownership of its productive assets, not in exchange for assets it will own abroad, nor to build other new facilities at home, but merely to finance systematic overconsumption. Having stunted its investment at home and dissipated its assets abroad, the nation now faces difficult choices because, unless it acts quickly to reverse these forces, we and our children will pay the consequences in the form of a diminished standard of living and a far different role for America in world affairs.

Although President Reagan consistently blamed Congress for the deficits that averaged $180 billion per year during 1982-88 (the 1981 budget was still President Carter's), the difference between the spending that Congress voted and what he proposed -- including defense and non-defense programs -- averaged only $17 billion. Even if Congress had adopted each of the Reagan budgets down to the last dollar item, the deficits and the economic problems that they have caused would have been not even ten percent smaller.

The real cause of the deficits the government has run during these years was that Congress approved the Kemp-Roth tax cut, which Mr. Reagan strongly supported, without matching spending cuts that neither Congress nor the President was willing to propose. As a result, we have had an economic policy that artificially boosts consumption at the expense of investment, dissipates assets, and runs up debt. We are enjoying what appears to be a higher and more stable standard of living by selling our and our children's economic birthright. With no common agreement, nor even much public discussion, we are determining that today should be the high point of American economic advancement compared not just to the past but to the future as well.

This decision to mortgage America's economic future has not been a matter of personal choice, but of legislated public policy. Popular talk of the "me generation" to the contrary, most individual Americans are working just as hard, and saving nearly as much, as their parents and grandparents did. What is different is economic policy. The tax and spending policies that the U.S. Government has pursued throughout the 1980s have rendered every citizen a borrower, and every industry a liquidator of assets. The main reason that the average American has enjoyed such a high standard of living lately is that since January 1981 our government has simply borrowed more than $20,000 on behalf of each family of four.

It is ironic, but probably true, that we would be more likely to address these problems if their consequence were some immediate economic cataclysm. The American political system has always been best at responding to crises. During the weeks when it looked as if the October 1987 stock market crash might be just such a crisis, prospects that the government might actually do something about its fiscal imbalance temporarily brightened -- only to fade as the fears themselves faded.

Defenders of the policies that have caused this imbalance have argued that the resulting overconsumption and underinvestment has had no serious implications, and will have none in the future, precisely on the grounds that there are no tangible, readily visible adverse consequences to which one can point. This argument is wrong, in that it ignores the stagnation of real wages in the current expansion, as well as the episodic loss of influence that our new status as a debtor nation has already brought. It also ignores the devastation of our agricultural sector and many of our key manufacturing industries -- autos, steel, electric machinery -- in the years when the U.S. government's borrowing drove interest rates here above those abroad, and therefore made dollar investments so attractive that the dollar became heavily overvalued. It also ignores other industries' continuing loss of sales to countries where production costs are lower, in part because we have underinvested.

Even so, it remains true that the most important costs of our current fiscal policy are not dramatic and obvious, but subtle and gradually corrosive over time. In many respects, that aspect of our nation's current problem is the most challenging of all.

Costs of Continuing Large Deficits

The unprecedented splurge of consumption financed by borrowing in the 1980s is eroding America's future prospects in two ways, each of which carries deep implications not just for our standard of living but for the character of our society more generally.

The more straightforward cost of our current economic policy is no more, and no less, than what any society pays for eating its seed corn rather than planting it. The federal deficit has averaged 4.2 percent of U.S. national income since the beginning of the decade, nearly three-fourths of the 5.7 percent of national income that individuals and businesses together manage to save after spending for consumption and for the replacement of physical assets (like houses or machines) that wear out. As a result, U.S. investment in new business plant and equipment has fallen to a smaller share of national income than in any previous sustained period since World War II. So has investment in roads, bridges, airports, harbors, and other kinds of government-owned infra-structure. So has investment in education (even including spending by state and local governments), despite the urgent need to train a work force whose opportunities will arise more than ever before in technologically advanced industries. In short, we are not investing in any of the makings of a strong economy.

Some observers have argued that government deficits do not reduce business investment, pointing for example to Japan, where both the government's deficit and business investment are larger, compared to national income, than ours. Such comparisons miss the point. What matters is how much saving is left over after the government borrows what it needs to finance its deficit. If our saving rate were as high as Japan's, we too could afford an even larger government deficit and still have enough left over to do more investing. But America has always been a low-saving country, and the supposed saving incentives enacted early in the Reagan administration proved extremely disappointing. What is different in America in the 1980s is not that we are saving so much less than before, but that the government is absorbing so much more of what we do save.

With so little investment in the basic structure of a strong economy, it is not surprising that our industry's ability to produce goods and services has been disappointing in the 1980s. Worse still, U.S. productivity has flagged despite the fact that some of the other forces that typically affect business performance have improved. Workers on average are older and more experienced, business has spent more on research and development, most of the investment needed to meet environmental regulations is already in place, and energy prices have fallen. But the weakness of business investment has overwhelmed these favorable developments. There has been no significant increase during the 1980s in the amount of capital at the disposal of the average American worker. And in part for that reason, since 1979 (the last year of full employment before the two business recessions that began this decade) our overall productivity growth has averaged only 1.2 percent per year. If productivity growth continues at this pace, we shall, at best, be able to do no more than pay the interest on our mounting foreign debt, leaving no margin to provide for increases over time in our standard of living. The further need to devote some 3 percent of our national income merely to balancing our export-import accounts will therefore have to come out of incomes that are already stagnating.

A second, and perhaps even more worrisome cost of our current economic policy is that it has weakened America's position in the world order. The great sums we have borrowed to finance our overconsumption have included large amounts borrowed from abroad. With government borrowing absorbing nearly three-fourths of our private saving since 1980, heightened competition among business and individual borrowers for the remainder has raised our interest rates, compared to inflation, to record levels, well above what investors could get in other countries. For half a decade, therefore, the dollar became ever more expensive in relation to other countries' currencies, as foreign investors competed among themselves to acquire dollars with which to buy high-interest U.S. bonds and other dollar IOUs. As the dollar rose, the ability of our industries to compete with foreign producers all but collapsed, not only in world markets but here in America too.

With the dollar so overvalued, we therefore increased what we consumed faster than what we produced, not only because we failed to invest adequately in new productive capacity at home but because we increasingly used our overvalued dollars to import more than we exported. The $25 billion gap between U.S. exports and U.S. imports of merchandise trade in 1980, considered a major problem at the time, grew to $161 billion in 1987. As we paid for this growing excess of imports over exports, we sent more and more dollars abroad, and foreigners then invested these funds in our financial markets. Indeed, because so little of what Americans save is left over after the government has financed its deficit, this re-investment of our own dollars by foreign lenders now accounts for most of the inadequate supply of capital that American business has available for investment. In 1987 the total amount that American businesses invested in new plant and equipment was $447 billion, or merely $75 billion beyond the mere replacement of worn-out facilities. The net flow of investible funds into U.S. markets from abroad came to $161 billion.

As our trade deficit continued to grow, throughout the 1980s, the great accumulation of dollars in foreign hands increasingly saturated the foreign appetite for dollar-denominated assets. The waves of selling that drove the dollar down in 1986 and 1987 had to come sooner or later. By now, after the most recent rise, the dollar is about back to where it was in 1980. With the dollar cheap again, our trade deficit has begun to shrink. But a significant correction will take time, in large part because we have underinvested in our economy as a whole and especially in industries like manufacturing that compete against foreign producers. As recently as 1986, total U.S. investment in manufacturing was only 1 percent above what it had been in recession-depressed 1982. We are increasingly learning that a cheaper dollar by itself is not enough. Our industries must also have the capacity to produce enough of what people here and abroad want to buy.

Even more important, as a result of our excessive borrowing we have, within less than a decade, dissipated our net international holdings and run up the world's largest net debt -- $368 billion as of the end of 1987, and probably more like half a *trillion* by yearend 1988. Now, therefore, we have not one debt problem but two: the debt that our government owes as a result of borrowing to finance its string of record budget deficits, and the debt that we as a nation owe as a result of borrowing from abroad to finance our string of record trade deficits. Even on the most optimistic trajectory, our debt owed abroad (over and above what foreigners owe us) will continue to grow in relation to our income for several more years, until we reach a debt-to-income ratio comparable to that of many of today's hard-pressed developing countries. If we allow our net foreign debt to continue to grow at its current pace until the mid 1990s, for example, our debt-to-income ratio then will be roughly equal to what Brazil's is today.

One grave implication of America's becoming a debtor nation is simply our loss of control over our own economic policies. Losing control over one's affairs is, after all, what being in debt is all about -- no less for a nation than for an individual or a business. Foreign investors who may become nervous about holding U.S. bank deposits and U.S. Treasury securities are perfectly free to buy up our businesses and our real estate instead. They are already doing so in increasing volume, and, given the vast amounts of dollars held abroad, it is clear that the process has only begun.

More important, world power and influence have historically accrued to creditor countries. It is not coincidental that America emerged as a world power simultaneously with our transition from a debtor nation, dependent on foreign capital for our initial industrialization, to a creditor supplying investment capital to the rest of the world. But we are now a debtor again, and our future role in world affairs is in question. Over time that role will gradually shift to Japan and Germany, or still other new creditor countries that are able to supply resources where we cannot, and America's influence over nations and events will ebb. Watching our economic power shift to these new creditors as they begin to cope with the developing world's debt, for example, or step in to prevent a "dollar crisis," in both cases presumably in ways that promote their own commercial or diplomatic advantage -- is merely the price we shall pay for the fiscal policy we have pursued throughout the 1980s.

Most Americans continue to think of themselves as creditors, and we readily offer unsolicited advice to other debtor countries, as if they had fallen into a trap that we had successfully avoided. Meanwhile, the Japanese and Germans still appear to think of themselves as debtors. But attitudes toward world leadership will change soon enough, as our financial problems circumscribe our scope for maneuver in world affairs while the new creditors' financial strength does the opposite. Just how large a departure from recent history the resulting new international arrangements will represent depends in part on whether, and how, we change our economic policy.

A New Budget Strategy

No change of policy, economic or other, can now neatly restore the damage done by the policy we have pursued in the 1980s. The assets we have dissipated are gone. The debts we have incurred are real. The full impact of these new economic facts has not yet reduced our living standards, because the excess of our consumption over our income that this policy has fostered is still under way. But this cannot go on forever, because the burdens of both our domestic and our foreign debts will continue to mount exponentially until, as many developing countries have found, no one is willing to hold either.

To limit the damage means, in the first place, not committing so much of our private saving, and foreign borrowing, to finance the federal deficit. Even so, there is nothing magic balancing the budget. There are times when either a deficit or a surplus is more appropriate to the nation's economic needs. Moreover, simply matching government income and expenditure makes even less sense when accounts are as crudely and arbitrarily measured as the U.S. government's. There is no reason to think that the many mismeasurements and outright omissions that are by now so familiar simply offset one another.

The best measure of a government's fiscal position, over long periods, is whether its debt is rising or falling compared to national income -- that is, the total value of the all goods and services that the country produces. Throughout two centuries of America's peacetime experience -- until the 1980s -- our federal debt was almost always declining in relation to our national income. The ratio of federal debt to income rose, sometimes sharply, in each of the wars we have fought. But once each war ended, we returned to repaying that debt, if not through outright budget surpluses then at least in the economic sense that, if the debt rose at all, it rose less rapidly than income. The only exception -- again, until the 1980s -- was in the early 1930s, at the bottom of the depression.

The guiding aim of American fiscal policy in the aftermath of the Reagan years should be to restore the federal debt to a declining trajectory compared to the nation's income -- and to do so without inflation. A declining ratio of debt to income will mark a return to the traditional U.S. fiscal posture. The 1980s will then have been a highly costly, one-time aberration. The nation will no longer be following a policy that is obviously unstable in the long run, and that is currently imposing a growing mortgage against future American living standards.

A sensible and cautious strategy for the next eight years should aim to reduce the debt ratio at about half the pace at which it has risen between 1980 and 1988, so that by 1996 the federal debt will then be no more than 34 cents for every dollar of our income. Because incomes will continue to grow in real terms, and because there will inevitably be some modest inflation, meeting this target does not mean eliminating budget deficits altogether. But it does mean bringing federal revenues and expenditures closer into line -- much closer into line -- than under President Reagan. If growth of national income during this period continues to average 2.5 percent per annum after inflation (as during 1980-88), while inflation runs at 3.3 percent per annum (the average since our unacceptably high inflation ended in 1982), total annual income will reach approximately $7.7 trillion by 1996. Debt equal to 34 cents per dollar of income would amount to approximately $2.6 trillion at yearend 1996, compared to debt outstanding (not counting what the government owed to itself) of some $2.1

trillion as of yearend 1988. This means limiting the growth of the federal debt to $500 billion over eight years, and the average annual budget deficit in those years to approximately $60 billion, right at $100 billion per year less than the deficit projected by the Administration for the current fiscal year.

Moreover, in estimating these magnitudes we should not take into account the surpluses -- almost $60 billion this year, more like $70 billion next year, and still larger in the 1990s -- currently accruing in the Social Security trust fund. To do so would defeat the purpose for which Social Security contribution rates were raised in 1983, namely to enable the Social Security System to cope with the burdens it will face early in the next century. The aging of the postwar baby boom generation will sharply raise the number of retirees receiving benefits compared to the number of workers making contributions. Without these surpluses now, there will be no choice but to raise payroll taxes for that era's workers to unacceptably high levels, or reduce benefits sharply -- just the outcomes that the 1983 legislation was intended to avoid. The target of $2.6 trillion of federal debt outstanding as of yearend 1996 should therefore include whatever amount of federal debt the Social Security fund may accumulate, and the target $60 billion average annual deficit during 1989-96 should include whatever part of each year's deficit the Social Security surplus may appear on paper to offset.

Getting from Here to There

What is necessary, therefore, is to narrow the deficit by roughly $150 billion from its currently projected level of approximately $210 billion (without the Social Security surplus). Achieving this objective will require three steps.

First, we will need substantial cuts in government spending. Smoke-and-mirrors accounting gimmicks will not do. Neither will sales of government-owned assets, which absorb private saving just like sales of Treasury bills. Making genuine progress in narrowing the deficit means making genuine cuts in federal programs. The notion that there are no possible areas in which to make these cuts is simply wrong. The Congressional Budget Office's "Reducing the Deficit: Spending and Revenue Options," issued just this month, lists over a hundred possibilities, ranging from the tiny to the huge. What may be impossible, however, is finding enough of them that were not ruled out -- presumably as a matter of political necessity -- during last fall's election campaign. Rhetoric about needless government programs notwithstanding, three fourths of all federal spending now goes for defense, Social Security, Medicare and Medicaid, and interest on the national debt. And the remaining one fourth includes such items as federal law enforcement, the courts, drug enforcement, our embassies abroad, the immigration authority, tax collection, highway construction, the space program, the national parks, disaster relief, public health, public housing, veterans' benefits, federal civilian and military retirement pensions, and child nutrition.

The relevant question is not whether it is possible to identify further potential reductions in non-defense spending, or economies in providing for our defense. There is no lack of possibilities. The real question is whether Americans actually want to implement these potential cuts, in sufficient magnitude to bring total government spending into line with total government revenues. The standard political rhetoric of the 1980s has repeatedly asserted that a consensus for such cuts exists. But the experience of the 1980s -- including the fact that President Reagan's total spending requests came so close to the total spending actually voted by Congress -- suggests that it does not.

Second, therefore, we will also need a tax increase. From a purely economic perspective, it makes little difference whether we solve the budget problem by cutting spending or by raising taxes. But a key lesson of the past eight years is that we are unlikely to solve the problem at all if we limit our attention to spending cuts only. Raising taxes would, of course, violate one of President Bush's campaign promises. But then so would cutting federal spending by enough to solve the problem without a tax hike.

If we make enough spending cuts, we may be able to do the rest of what we need with such "revenue enhancements" as higher taxes on gasoline, tobacco and alcohol, and higher user fees for services that the government provides. Otherwise, solving the problem will require either an increase in income tax rates or the introduction of some new kind of tax. A consumption tax would be preferable, for reasons of economic efficiency and incentives. So would a European-style value added tax, which is like a national sales tax. But if nobody has the will to reopen the debate about what form of tax structure America should have, it is worth remembering that merely raising the two benchmark rates in our current income tax from 15% and 28% today to 18% and 31%, respectively, would generate $75 billion per year of additional revenue, on average over 1989-96 -- fully half of the deficit narrowing that we need.

By contrast, President Bush has suggested that a "flexible freeze" on federal spending -- specifically, restraining growth of all federal spending, other than the Social Security program, to no more than the rate of inflation -- can do the job without requiring additional revenues. Wholly apart from the important question of whether the economic assumptions underlying this claim are overly optimistic (an issue that has already received substantial national attention), the very concept of the flexible freeze, as President Bush has described it, is questionable in several key respects.

For example, what if interest rates remain at their current ~~levels~~ (or go higher), instead of falling substantially as the administration predicts? Some descriptions of the flexible freeze have included the interest paid on the national debt as part of "all federal spending other than Social Security," so that sticking to the flexible freeze would then mean having to enact (perhaps even after the fact) some billions of dollars of additional cuts in non-interest spending, so as to offset the larger interest payments. Other descriptions of the flexible freeze have excluded interest from the catch-all of spending to be limited, so that the success of the flexible freeze in achieving its stated objective will depend crucially on whether the forecast of declining interest rates proves accurate.

As another example, what if resolving the growing distress in the savings and loan industry requires more than the relatively small amounts called for by the administration's new rescue plan? If this spending is "on budget," then, once again, sticking to the flexible freeze would mean finding an equal amount of additional cuts, beyond those initially proposed, in other spending programs. If it is "off budget," then the flexible freeze might be successful in some technical sense, but the sales of government debt -- in this case the debt of some specialized agency, rather than of the Treasury directly -- would continue to absorb our private saving anyway.

For this reason -- including not just these two obvious examples, but many others besides -- the "flexible freeze" is not likely to be successful. Confronted in the future by its lack of success, the current advocates of this strategy will no doubt say that it never worked because it was never tried. And, in a technical sense, they will be right. But the reason why the flexible freeze will not have been tried, in that sense, is that it is itself so unworkable. I therefore believe that righting the government's fiscal imbalance, under today's circumstances, will instead require some combination of actions involving both spending restraint and increased revenues.

Finally, we will also need an easier monetary policy -- but only _if_ we cut spending enough and raise taxes enough to make real progress in narrowing the deficit. Nobody wants a recession, and it is possible (though far from certain) that a major tightening of fiscal policy would have just that effect if the Federal Reserve did not offset the reduced stimulus to total spending by lowering interest rates. After all, there is nothing wrong with our level of economic activity overall. The problem is that there is too much consumption and too little investment, too many imports and too few exports. The best way to correct those imbalances without risking a recession is to shift our policy mix, matching a tighter fiscal policy with an easier monetary policy.

The economic policy that we have pursued in the 1980s -- a policy based on large tax cuts not matched by spending cuts -- has produced record budget deficits despite peace and full employment, and a national debt that is rising compared to national income. As a result, our investment in domestic capital has been eroded, and for a while our international competitiveness all but collapsed. Without economic growth, American society will ultimately lose its dynamic sense of progress, its capacity to accommodate the aims of diverse groups within the population, its ability to offer the remarkable social mobility and individual opportunity that is its hallmark. Without a strong and competitive economy, America as a nation will watch others take its place in the world order. These are the real costs of our current fiscal policy. The fact that they are occurring gradually over time, rather than in some readily visible market collapse, does not make them any the less real or the less disturbing. It is time for a change.

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Mr. Chairman, thank you for the opportunity to present my views to the committee.

Representative **Obey**. Thank you very much.

Congressman Upton.

Representative **Upton**. Thank you. I do have a couple of questions, Mr. Litan. In your talk with regard to the savings and loan, of course the deficit figures that Mr. Friedman indicated are correct, that they have gone down from 220 to 127 is what the projection is for 1990 by CBO. A lot of that has been because of the Social Security trust fund. As a percentage of GNP, of course, they've dropped; in addition in real terms they've dropped as well.

One of the big reasons that you were citing with regard to the rate of savings, and despite a reduction in the deficit, both real numbers as well as a percentage of GNP over the last couple of years, I believe that the savings rate has also declined. During the same time that the deficit has actually declined, the savings rate has also declined.

What would be your thoughts with regard to that?

Mr. **Litan**. Well, you've touched on one of the puzzles. The decline in the national savings rate from roughly 7½ to roughly 3 percent of GNP is due equally to a drop in government savings and a drop in private savings.

What my prepared statement pointed out is that frankly we don't, as a profession, have a very good understanding why the private saving rate dropped, and particularly why the personal savings rate dropped in the 1980's. There are all kinds of speculations. Some think that the savings rate dropped because stock prices increased. People felt richer so they didn't have to save.

There are demographic explanations; that with the aging of the baby boom generation, actually we should soon be getting an increase in saving. In contrast, during the first part of the decade the baby boomers there spending like crazy and so maybe that was a reason for decline in the savings rate.

There are a lot of theories. I think it's fair to summarize the economic literature to say that most of the speculation is inconclusive and that we really don't understand fully the reason for the drop in the private savings rate. But we obviously understand the reason for the drop in the Government's savings rate. We can do something about that.

And so operating on the premise that if you want to do something about the national savings rate, and you want to take some steps that you know will work, well then do something at least about the Federal budget deficit because that will increase national saving.

Maybe Ben Friedman has something to add.

Representative **Upton**. Do you have comment with regard to that?

Mr. **Friedman**. Congressman, I think one of the main lessons of the 1980's ought to be a profound skepticism about our ability to increase private saving. Because of a combination of actions which Congress legislated and market forces, lots of the things that people told us in the 1970's would raise private savings took place.

We cut tax rates. Pretax market interest rates, net of inflation, rose to record highs. We put in place targeted savings incentives. Capital gains tax breaks came down. We had individual retirement accounts. The top rate on interest and dividends was cut from 70 percent to 50, then to 38, and so forth.

Despite all of this, the saving rate fell. Bob Litan is absolutely right. We don't know why the saving rate fell, but surely nobody can look at this experience and come away with any confidence that he knows what to do in order to get the saving rate to go back up. Most of the proposals on the table amount to more of the same that we did 8 years ago.

Representative **Upton**. Mr. Friedman, speaking about capital gains for one second, that's one thing that you did not talk about in your oral testimony.

What are your thoughts with regard to the Bush proposal on lowering the capital gains tax to 15 percent as has been indicated in the State of the Union address?

Mr. **Friedman**. I have a variety of reactions to it, Congressman. First, I think that the focus on the revenue effects of the proposal is very misplaced. My colleague, Larry Lindsey, has done a serious piece of work suggesting that there might be a small revenue enhancement. The CBO has done a study, equally serious, suggesting that there would be a revenue loss. When serious economists come up with a range of evidence ranging from a small plus to a small minus, one should probably assume zero and go on from there.

I think the more important issues are, first, whether a cut in the capital gains tax would really be likely to stimulate entrepreneurship and, second, whether doing so would cause many of the favorable aspects of the so-called Tax Reform Act of 1986 to unravel.

The latter point is more of a political matter, and my expertise isn't in that field. The fear is simply that, once we start giving special breaks for capital gains, for oil and gas drilling, and so forth, we run the risk that every other special interest group in town will come in asking for breaks for its constituency.

On the entrepreneurship front, I think the results of having lowered capital gains taxes sharply, which we did first in 1979 and then again in 1981, have been very disappointing. It is true that there has been a good increase in capital gain commitments and disbursements in the 1980's. What strikes me, however, is the large fraction of that increase that has come from tax-exempt investors.

An example: I work at Harvard University. Harvard University is tax exempt—fortunately. Harvard is now one of the major players in the venture capital business in the United States. There are plenty of other examples: the Howard Hughes Medical Foundation: the GM and GE pension funds; and others. These are the sources of the major surge in venture capital disbursements in the 1980's—not exclusively, but for the most part. It's very difficult to tell the story by which any of these investing institutions cares very much what the capital gains tax rate is.

So if there is any fear that doing this would cause the other parts of the 1986 bill to unravel, then I would say don't do it. If that fear is not a concern, then I see no great argument against it.

Representative **Upton**. I would be interested in both of your comments, going back to the savings rate. Part of it, I think, there may be an attitude among many Americans that the Social Security trust fund is solvent. After what Congress did in 1983, there's no window of vulnerability in the next decade. We've seen a tremendous rise in pension funds, Keogh funds, though we've lost IRA's, though they are still available for those that don't have a retirement fund.

But how might those retirement funds affect the savings rate? Has anyone done any studies with regard to that?

Mr. LITAN. Let me talk about the Social Security trust fund. I find that when I talk to public audiences, there is an enormous amount of confusion about this issue.

As an accounting device it's clear that the Social Security trust fund is running a surplus and is going to run a bigger and bigger surplus because we're taking the money that we collect and we're putting it aside.

Now, economists tell you that that's fine as an accounting device, but unless you increase your national savings rate, then simply taking that money from one trust fund to pay for current expenditures will not increase the national savings rate. So, in 30 years our national income will not be materially higher, or as high as it could be, and we will be forced, since we spent all that money for 30 years, to raise taxes on Social Security 20 or 30 years hence to pay for the retirement of the baby boomers.

Now, I find it easier to understand if I explain this problem from an individual's perspective. Let's say you want to save money in your IRA and you Keogh account and you put aside $1,000 every year. And you are assuming that at the end of 30 years, that money is going to be there for your retirement and it's going to earn interest, and you're going to be in good shape.

But what if I told you that, instead, every year all we did is take that $1,000, put it in one account, and then you turned right around and you borrowed it back from yourself and you spent it every year. And you put in an IOU saying sure, I'll pay it back sometime later, but you spent it year in, year out. Well, then you would find that in 30 years you wouldn't have built up any extra savings and you'd be facing retirement with nothing there.

And so what would you do? You would turn to your kids and you would say, "Look, I'm out of money. You have to give me some money to live on." Well, that's in essence what our Nation is going to do if we don't save that Social Security surplus in a real sense by basically balancing the budget on the non-Social Security part, so that the Social Security builds up a real increase in savings.

What we're going to do in 30 years is we're going to say:

> All right, kids, we're going to increase your payroll taxes by 50 percent because that's what it's going to take to pay our Social Security and Medicare benefits. You're going to have to have that increase in order to pay for our retirement.

And you know what they may say to us? "Tough. We're not going to do it. We're not going to give you the money." Or they're going to say, "Work 5 or 6 more years," stretch out the retirement age. And, frankly, they would have a right to tell us to do that because we wouldn't have taken the moral and political choice now to save for our retirement.

So the bottom line is, we have to come close to budget balance on the non-Social Security part of the budget if we're going to have any realistic hope of saving all that extra money that we're putting aside in the trust fund.

Mr. **Friedman**. I have nothing to add on Social Security, Congressman, but I'll mention two brief things about the non-Social Security part of your question.

First, some people have suggested that a reason for the decline in the saving rate in the 1980's has been that, with ERISA passing its 10th birthday, more and more private pensions, as well as the State/local governments that followed along even though they didn't have to, were fully funded. Therefore the pace of contribution to these institutionalized saving vehicles fell.

It is true that that happened. But quantitatively, the effect was way too small to explain any more than a small fraction of the decline in private saving. It just isn't true that the maturity of the ERISA legislation, with the consequent dropoff in corporate pension funding, is a full explanation.

Second, if I were to pick out one saving incentive that we enacted in the 1980's that looked, on the basis of what evidence we have now, as if it might actually have been in the process of working, I would pick out the IRA legislation. Therefore I regarded the restriction of IRA's that was enacted as part of the 1986 legislation as a very counterproductive part of the bill; once again, not because we know for sure that saving incentives work, but because the IRA is the one for which there does seem to have been some evidence that it was in the process of having a positive effect.

Representative **Upton**. I'm glad we are able to agree on that point. Thank you.

Thank you, Mr. Chairman.

Representative **Obey**. Just an observation before asking my questions. You indicated we ought to be skeptical about claims that are made about any public policy change in terms of the effect it could have on private savings.

I see so many arguments used for so many things around here, regardless of whether they have any connection or not. I'm reminded of an old story when Earl Long was the Governor of Louisiana. And one of his young relatives came to him, who was in college, and said, "You know, I'm going to be on the debate team." The Governor said, "What's the topic this year?" And he said, "Well, the question is: Should ethics be used in determining government policy on virtually every subject?" And the Governor said, "What side are you on?" He said, "I'm going to be on the affirmative side. Should be." He says, "I agree. You should use anything you can get your hands on."

I have been puzzled by the puzzlement of economists when they look at the question of decline in the national savings rate. I guess I'm not especially baffled by that because it seems to me that if your numbers are right about what has happened to real family earnings power over the past few years, it seems to me the answer is pretty simple. If I have the money and can afford, I save; and if I don't, I pay my bills and hope that sometime down the line my income increases so I can.

It would seem pretty clear to me, especially since 1973 when we had the first oil shock and everything got turned around in this economy, and if you couple that with the demographic changes that we've had, that those are two pretty logical explanations for it. And I wonder sometimes whether we don't try to get intellectual double hernias worrying about something we can't affect very much and that in fact the answer is probably pretty simple. People just didn't have the moola.

Did you want to comment on that?

Mr. **Litan**. Yes.

I think a lot of economists in their gut think that your story has much to recommend it. Of course, what economists love to do is run statistical regression analyses to try to explain everything. One of the problems that you have in converting this sort of declining income growth story into a declining savings rate is this—and here I would take maybe a minor exception to Ben Friedman's emphasis on real wages.

An increasing portion of our total compensation in our system is fringes. And so if you look to total compensation rather than wage growth, there has been a very small rise in real total compensation since 1973. It's on the order of about a half a percent a year, versus over 2 percent a year before 1973. So we still have had a marked slowdown but we've had a mild increase in compensation growth.

Well, the reason I mention that is that between 1973 and 1980, real compensation was growing at about half a percent a year and the savings rate was still pretty high. Private savings was still in the 6 or 7 percent range. And then in the 1980's, real compensation growth continued at the same rate—very slow, 0.5, 0.6 percent. And then the savings rate falls off the table, down to the 2 and 3 percent numbers that we see today.

So it may be true that over the entire post-1973 period the slowdown in wage growth and in compensation growth had some effect on the savings rate, but we have a hard time at least understanding why that rate fell off the table after 1980.

Representative **Obey**. But didn't you also have something else happen in the late 1970's? When inflation expectations became so heavy, it seems to me around that point, with some lag factor, you would also have a disinclination to save because people thought if they did it would be worth less than if they spent it immediately.

Mr. **Litan**. True, but then inflation came down, and you would expect that effect to dissipate.

Representative **Obey**. I'd expect it to dissipate by the middle 1980's. I don't know if I'd expect it to dissipate much before, say, 1982 or 1983.

Mr. **Litan**. OK. But there has been a real falloff in the savings rate in the last 3 years or so. So again, I mean why? It's frankly a mystery.

By the way, I'll just offer my wife's theory on this.

Representative **Obey**. It's probably as valid as anybody's in this room.

Mr. **Litan**. You know, my economist friends laugh at me all the time. She says it's the nuclear war effect. More and more people from the baby-boom generation think that all these calamities, the greenhouse effect, nuclear war, et cetera, can all befall us sometime in the future, so why save now. And as more and more of those people occupy the labor force, then they're having greater and greater effect. Who knows?

Mr. **Friedman**. I'm actually more sympathetic to your explanation, Mr. Chairman, than Bob Litan is. Incidentally, I wonder whether this is now the accepted congressional explanation. Only yesterday I testified before a different committee, and the chairman, Jim Sasser, also expounded the same theory exactly.

Representative **Obey**. Well, good. I'm glad to know somebody around here agrees with me on something.

Mr. **Friedman**. He had the same view you did. I think there's a lot to be said for it, but there are a variety of reasons why it's hard to show this conclusively. Too many things are going on simultaneously. But I think there is a lot to be said for this idea.

Americans, after all, had become used to a sustained, upward movement in the standard of living, generation after generation. That's part of the ethos of American society. Until recently that was grounded in the improvement in what we were able to earn to support out standard of living, but that is now no longer there. If people continue to think that they ought to be able to improve the way they live, year after year, yet they don't have the increases of income to support it, then until they get used to the new environment their saving is going to drop. So, I'm more sympathetic to the chairman's notion, even though I am no more able to document it conclusively than anybody else.

Representative **Upton**. While the chairman is on the phone, let me just make the point that I see certainly as a baby boomer. There are a lot of us in the room. You know, 20 or 30 years ago when you looked at Social Security and people looked at that as the retirement fund that would hopefully take care of them in the future, and the taxes were in fact less than 2½ percent of the wage income.

Today, of course, it's over 7 percent. It's going to go up again later this year another half percentage point. And in fact, really when you look at the savings rate, you really ought to take into account the money that we all today are putting into that Social Security trust fund as part of our forced savings rate.

Wouldn't you agree?

Mr. **Friedman**. Yes, sir. That's exactly the point and when the Government simply takes——

Representative **Upton**. But is that included as part of the 3 percent savings rate, or whatever it is today? It's not, is it?

Mr. **Friedman**. Yes, sir. It is.

Mr. **Litan**. It's counted as government saving. I mean it's on the Government account. So sure, it's part of total net national savings.

Mr. **Friedman**. Right. The point is, Congressman, that you can either think of that saving being a part of private savings, in which case the Government dissaving is then measured by the onbudget deficit; or you can think of that Social Security surplus as not being part of private saving, but as making government dissaving less. But regardless of whether you think of it as enhancing private saving or minimizing the Government's dissaving, by the time you put the private saving and the Government dissaving together, it's in on one side or the other and it certainly is a part of what we think of as our national saving.

Mr. **Litan**. Yes, I agree.

By the way, I just have one comment on the capital gains issue that Ben Friedman was talking about. I tend to feel somewhat strongly about the unraveling effect, and it's not so much from the point of view that additional lobbying groups are going to come to you and want additional tax breaks.

Suppose there were no additional demands, tax breaks, and all you did was change capital gains. What that would do, without additional tax breaks, is that it would re-create the tax shelter industry. Most of the tax shelters are driven by the desire to convert ordinary income to capital gains. And so reintroducing a capital gains differential just re-creates the entire industry that theoretically was supposed to be killed off by the 1986 tax reform.

Representative **Obey**. Mr. Niskanen indicated that he wasn't so much worried about whether we dealt in large enough fashion at this moment with the S&L crisis as he was that we did it rapidly.

I'll give you my political reaction to that and then ask you for your economic reaction. My political reaction is, I don't enjoy going to my taxpayers once and telling them, "Sorry, but you guys are going to get stuck with cleaning up the mess." I would really hate to have to do it two and three times.

But political inconvenience aside, do you agree with Bill Niskanen's statement or do you think there is some reason why we ought to worry about whether this proposal ought to be expanded sufficiently if it appears to be inadequate to meet the need?

Mr. **Litan**. I'm glad you asked that question. Let's start with some premises. We got into this mess largely because we didn't tackle it early enough and the more we delay the issue the worse it's going to get. So obviously the quicker we do it, the better.

Now, from a purely political point of view, it seems to me a mistake for both the administration and for you in Congress to err on the cheap side, which we've doing all along throughout the 1980's, because for the reason you point out, if you err on the cheap side—$50 billion I don't think is going to be enough—then I think there is a significant likelihood that you're going to have to go back in 1991 and do it again. And then your constituents are really going to be mad.

Although personally, as a political matter, I think the administration is going to take even more heat for it. And so I can't understand their political miscalculation of going in with a low number.

So what I would have done, and you still have a chance to do, is raise the total borrowing authority. Instead of $50 billion, why not ask for $80 or $100 billion? Now, if you err on the high side, and then in the course of the cleanup, the FDIC doesn't spend all the money, then fine. Then the administration can come back to you and say in 3 years that they cleaned it up for less and they didn't need the extra money. And then at least, you wouldn't have to do this over and over again.

But let me tell you there's an economic reason why it's good to know, if you're in the administration, specifically in the FDIC, that there's a lot of money there. Look what happened in 1988. Everybody has been criticizing the Bank Board for doing all these deals and giving away tax breaks, et cetera. And, frankly, no one is ever going to know the truth until several years later, until we can figure out all the accounting that was done on these deals, and that's been a problem because a lot of them are secret.

But the reason Danny Wall was doing this, of course, is that he had no money in the bank. And if he was overly generous in any particular case, it's because he felt that I have to do something to clean up this mess, and so if he gave away the store it's because he felt he had no other choice.

Now, if you don't give enough money to Bill Seidman this time around, then he in 1990 is going to end up like Danny Wall in 1990 or 1991. His money is going to be almost gone. In my prediction, he's going to face several hundred more thrifts that still have to be cleaned up, and then he's going to have to say:

> Well, I'm running out of money. I can either start giving away the store to start cleaning this up like mad for political or other reasons, or I can tell the administration to go back and ask you for more money.

Now, this is not a very wise position to put somebody in because, frankly, we don't want to give away the store if we can avoid it. We don't want people to come into this industry that are undercapitalized, for regulatory reasons or whatever. So for both economic and political reasons, in my opinion, you should err on the high side. And if you don't need it, well then fine and good. But you have one chance, in my opinion, to do it right this time and hopefully you'll do it right and provide enough money, or perhaps even more money than you think, so that at least you know it's there in reserve.

Mr. **Friedman**. I think that's right, Mr. Chairman. There's another dimension, too. I think something has to be done to take away people's incentive to issue federally guaranteed liabilities, and then take high risks on a basis such that, with limited liability, the owners of the institution stand to absorb all of the gain if those risks work out well and none of the losses if they work out badly.

There are a variety of actions that have been proposed for this purpose. One is to reregulate the industry, to limit the kinds of assets that these institutions can invest in. To me, a more attractive proposal would be to scale the insurance fee so that those institutions that have higher risk assets pay a higher insurance premium on their liabilities. But doing something in this regard is clearly going to be necessary. No matter how much it costs to solve the problem of those institutions that are in trouble now, unless we remove the very strong incentives to go out and do this kind of activity, we're going to have the problem come back again and again and again.

Mr. **Litan**. I want to underscore that, because I pointed out in my prepared statement, perhaps the most important proposal in the Bush plan is not the money, it's the capital standards by 1991.

Representative **Obey**. It's the what? I didn't hear you.

Mr. **Litan**. It's the capital standards. It's the requirement that thrifts meet those tough capital standards. And many thrifts are going to be in there, they already are, arguing to delay those things and postpone them. I can guarantee you that if you postpone those standard 2 or 3 more years, you're going to have this problem again. One, you're not going to clean it up, and, two, you're going to have it again.

Representative **Obey**. Congressman Upton had a followup question.

Representative **Upton**. Just a quick question. I met with a number of my S&L's, as did the chairman the last couple of weeks. One of the big subjects of conversation that we had last week was in fact this theory of the risk; that those at the bottom end would pay a higher premium, et cetera, those that were doing better.

How would you possibly set something up like that, which would not bring about the demise of those that perhaps otherwise might make it by giving them a higher premium?

Mr. **Friedman**. Congressman, there's a table in Bob Litan's testimony that is very useful in this regard. Table 2 in Bob's testimony shows that thrift institutions vary enormously according to the amounts of their assets that are in various kinds of high-risk investments. His is a limited breakdown, but more detailed ones are available. Moreover, because this table looks at aggregate categories, like all Texas thrifts, or all California thrifts, it enormously understates the institution-by-institution variation.

Most of the proposals that are around in this regard take the form of saying that if you're going to run your thrift in a way that has substantial amounts of what are here called equity-at-risk investments, or what are here called junk bonds, then you ought to pay a higher premium to the insurance authority than somebody who is by and large doing relatively safe single-family home mortgages in and around the bank's own city.

Mr. **Litan**. Congressman Upton, let me follow up on this issue because it's actually been, I think, well studied by a lot of the academics that have focused on this industry. In the early 1980's, there was a lot of enthusiasm for so-called risk-based deposit insurance premium pricing. There is a lot less enthusiasm for it today, frankly, because of the concern or a fear by a lot of people that you can't do these assessments that accurately. You do them in a gross sense, which Ben Friedman's referring to, but not in really a fine-tuned sense.

And so what the regulators have moved toward, at least in the banking community, is risk-based capital standards. And they look at these asset categories and they require you to have more capital against the highly risky things.

Now, in theory, these are equivalent ways to go about the problem. You either charge people higher premiums or require them to have more capital based on risk. Our regulators, it just turns out, have been moving toward the capital approach. And in fact, the Bank Board which regulates the thrifts has a proposal out now to adopt for the thrifts the same kind of risk-based system that we have for banks, but it goes even further. It not only looks at the individual risk of the different asset categories, but it puts on them an additional capital requirement for so-called interest rate risk. If they want to take interest rate bets, they even have to have more capital.

A lot of the thrifts are screaming about it, but it's a good thing, because capital is the ultimate buffer for the insurance agencies. Since we're already moving in the capital direction, I guess I'd say let's just go in that direction the way it is. And that returns to my previous comment. The key to preventing the thrift problem from resurfacing is tough capital standards.

And if capital falls below a certain level, but still above zero, let's take the institution away from them, auction it off to somebody else and give the shareholders the money from the auction. And if the auction doesn't fetch anything, at least the Government has minimized its downside loss.

Representative **Obey**. Mr. Friedman, in Bill Niskanen's testimony this morning, he made the comment that in effect borrowing from the future generation's standard of living to finance ours is in fact immoral. And I think that is generally agreed.

But I would ask this question. We do deal in relative degrees of morality or immorality just like we deal in relative degrees of wisdom or lack of wisdom. Isn't it true that while it might be immoral to transfer the payments for our style to a future generation, you could structure a situation in which the degree of immorality that was attendant to a policy which continued to refuse to address issues such as homelessness or lack of educational or any other kind of opportunities, the degree of immorality imposed on an individual today could in fact be greater than the degree of immorality being imposed on someone in the future because they had a reduction in the amount by which their income would otherwise grow?

Would you disagree with that?

Mr. **Friedman**. No, I don't disagree. I think that's absolutely right. The only other point I would make, though, is that the reason why we have the Federal deficit today is not that we have enormously increased our spending on the homeless.

Representative **Obey**. There's no question. We haven't. I wasn't suggesting that by any means.

Mr. **Friedman**. If the first thing we do to eliminate the deficit is to turn exactly to that kind of spending cut, then I think you're right. Which is worse?

I'm sure you gentleman are aware that a broad look at what the Federal Government actually spends its money for does not lead to programs like that targeted for the very, very disadvantaged, as the source of the problem.

Representative **Obey**. No, I totally agree with that. What I'm leading up to is this. I've read your prepared statement and I have been singing much the same song for the past few years, not as well perhaps, but singing it nonetheless. But any thoughtful person around here from time to time will begin to doubt his own baloney as well as the next guy's.

And so my question is, I have a series of questions because you know some of the counterarguments that are made to the thrust of your book by some very well-grounded, solid, thoughtful people.

They were summarized, they've been summarized a lot of places, but they were summarized, as you probably know, in a short New York Times magazine article by Charles Morris a few weeks ago. I was reminded of that article last night as I read your prepared statement.

Mr. **Friedman**. Many people were apparently reminded of my book when they read that article. Perhaps the connection was not accidental.

Representative **Obey**. Well, I wanted to give you an opportunity to respond to some of the points that he made in his article. You indicated, for instance, your concern about the weakness of investment. He indicates, for instance, that we are really counting wrong, that we are the victim of faulty depreciation estimates, for instance, and that maybe we shouldn't be worrying as much as we seem to be worrying about it.

What's your response to that?

Mr. **Friedman**. Whether to look at investment gross or a net is a very subtle issue, Congressman, and in my book I went into it in some detail.

The issue is whether, when assets are depreciated, we think that there's a lot of gain or just a little gain by replacing them with other assets that are not, of course, identical to what wore out. You don't take a 1950's era machine and, when it wears out, replace it with something just the same.

Even inclusive of the depreciation, however, our recent investment performance has been pretty disappointing. People often point to the fact that, inclusive of depreciation, the 1980's have seen a higher average investment rate, measured as investment divided by our national income, than we had in the 1950's, 1960's, or the 1970's.

That's true. But if you look at the year-by-year path, you discover that we had been building that gross investment rate steadily up to a peak in 1981. After 1981, it started declining. If you calculate the average gross investment rate for the 1980's and ignore the fact that the trajectory is downward, then, because it started at the high level to which successful policies from 1950 to 1980 had brought us from this perspective, the average rate from the 1980's is superior. But because the trajectory is going down, I think that argument is not very compelling.

Even people who think that the right measure is gross investment rather than net, so that one is counting in all of the new gross investment, including all of the depreciation, should still be concerned about what's happened in the 1980's.

Representative **Obey**. You make the point that many people have made about the United States becoming the world's largest debtor nation. Again, the argument made by Morris and others is simply that America's overseas investments were made earlier and that U.S. assets abroad have a lower book value, and so again we're not comparing exactly the correct things.

What is your response to that?

Mr. **Friedman**. That is exactly correct, as far as it goes.

As I explained in some detail in my book, the official Commerce Department accounts are deficient in four ways. Two of those go in our favor, two go against us. The two in our favor are the points you just cited, about the greater antiquity of our physical holdings overseas, and also the undervaluation of our gold holdings.

Two others go against us, however. First, the Commerce Department carries on the books, at face value, nearly 300 billion dollars' worth of loans to developing countries, including loans that Lehman Bros. prices in the market at 18 cents on the dollar.

Representative **Obey**. Try 10.

Mr. **Friedman**. It depends on which country and which day, sir.

Second, there is a net balance of unrecorded capital inflows over unrecorded capital outflows, amounting to about $20 billion a year. If we merely take the last decade worth of the aggregated unrecorded inflows over unrecorded outflows, then that's yet another very big adjustment.

I think, however, that the whole issue is a big red herring. What difference does it make whether we became a net debtor in 1985, as the Commerce Department numbers show, or in 1988 as a Rand Corp. study showed? Yesterday I was at the Senate Budget Committee, and there was an economist there from Rand who had the same story. The bottom line was that years ago we used to have an even greater net investment position than the official numbers show, and therefore, even though we're running it off, we didn't cross this over the imaginary zero line until 1988. It didn't happen in 1985.

I don't think we should be concerned about whether it occurred in 1988, or 1985, or maybe it hasn't even happened yet. The main point is that we are, at a very rapid pace, dissipating whatever positive net international investment position we once had. Whenever we crossed over the line, or whenever we do cross over the line if it hasn't happened yet, we are running up a net debtor position at a very rapid pace. That trajectory has very profoundly disturbing consequences.

Representative **Obey**. What about the argument made by Bob Eisner and others that if you take into account the fact that half or so of the interest rates that we're getting hit with in fact simply represent an inflation factor, and when you add to that the fiscal condition of other public spending entities at different levels of government, that in fact that is much smaller and we should not be worried about it as much.

What is your response to that?

Mr. **Friedman**. I have two reactions. First, on the inflation correction, it's absolutely correct that some of what we pay as interest ought to be thought of as repayment of debt principal. The irony is that that's smaller now than it used to be years ago.

When Eisner began that work, our deficits were a lot smaller than they are now, and inflation was a lot higher. If you calculated the inflation correction on the debt properly, by and large the deficit went away. But as he kept going, two things happened. One is that the deficits got a lot larger and, second, to the credit of the Reagan administration, something was done about inflation. Therefore the inflation correction is now smaller, while the deficits are bigger. Therefore I don't think that argument is very persuasive.

The State and local governments have been running a surplus in recent years. That is primarily a surplus in their pension accounts, not on general account. But that surplus has peaked.

If there was the prospect that that surplus would continue growing, that would be a very serious argument. But the State-local government surplus peaked at $65 billion in 1985 for the aggregate surplus for all State and local governmental units. Since then, it's fallen by a little more than 20 percent, even in dollar terms. The State and local government surplus is coming down, and so I don't think that's a very good answer either.

Representative OBEY. I understand you have to catch a plane at 1 o'clock, so you probably want to get out of here in about another 5 minutes. I have about three other questions I'd like to ask you here and then perhaps several more for the record.

You say in your prepared statement that from a purely economic perspective, it makes little difference whether we solve the budget problem by cutting spending or raising taxes. Some people dissent from that view.

What makes you say that? Why should a spending cut and a tax increase have the same effect on the performance of the economy?

Mr. FRIEDMAN. They don't. But as long as we don't have foolish spending cuts or foolish tax increases, I would regard the difference between those two ways of narrowing the deficit having economic effects that are second order compared to the major effect of freeing up our saving to go into investment rather than siphoning it off into a government deficit.

Representative OBEY. Let me ask you, if you could wave a magic wand and be king for a day, what would you do to deal with the budget deficit, the trade deficit, all of the problems you've been talking about in your book and your prepared statement and we've all been talking about this morning?

What ideally would you do on fiscal policy, economic policy, budget policy? What would you do on the revenue side? What would you do on the spending side? Or where would you not cut? Where would you cut deeply? Do you have any views on that?

Mr. FRIEDMAN. Yes. I would aim for a deficit of approximately $60 billion, exclusive of Social Security. For fiscal year 1990, that means pretty much a balanced budget, although I would phase this in over 2 years so as to avoid a sudden economic crunch. I would divide that deficit narrowing about half on the spending side and half on the revenue side.

On the spending side I would probably spread that over as broad a base as possible, including as many programs as possible. But if I were to start exempting programs, I would begin by those that have a visible investment component.

Representative OBEY. Let me ask you about that. That's one of the trickiest issues to deal with because everybody who favors a program calls it an investment, calls the other guy's program a consumption.

Mr. FRIEDMAN. Yes, that's right. That's why I think doing it on as broad a base as we can is probably the best that we are able to do.

Representative OBEY. What I'm getting at is, Bill Niskanen this morning in his prepared statement indicated great concern that we focus on capital investments. My question is in terms of adding to productivity, in terms of facilitating our ability to grow in a noninflationary way economically, how do you get at defining investments in other production units of the economy; that is, the people running those units?

We always hear economists saying we're very much in favor of R&D. That in itself is very hard to define and people can sometimes get away with murder in terms of what they call R&D. But how do you define, how do you classify investments or spending, I should say, in education or in job training? Do you regard that as critical investment equally with capital——

Mr. **Friedman**. Yes, sir; I do. But again, there are precisely the difficulties of definition that you describe. Also, let's be frank. Many times activities that in principal are investment activities; either because they're building something physical or because they're training some people, are, in the particular, doing what they're doing not for some other reason—for example, to have a job creating a building program, or to get some people off the streets and pretend to train them.

I agree it is very difficult to define these things. The question is, How do you go about this? The best advice I could give is to stay away from it, to spread your cuts across as broad a base as you possibly can. Once you go down the road of saying that you're going to exempt this and exempt that, you probably will have so much trouble and so much debate over it that nothing will get done.

I also don't want to fail to address the other piece that you asked me about—the revenue side. I said I would do about half of what is necessary on the spending side. On the revenue side, I think the best idea would be a value-added tax or, as many people call it, a national sales tax. If we're trying to raise $50 billion per year, that would require approximately a 2-percent value-added tax. But, because a value-added tax in its straight form is clearly regressive, we would probably want to exempt necessities. If we exempted all purchases of food, clothing, housing, and medical care, we would then have to have not a 2-percent value-added tax, but a 4-percent value-added tax on the remainder.

Representative **Obey**. Let me carry that on with you for a moment, since you have to leave. Theoretically, I can live with that, but I don't live in a theoretical world, nor does anybody else in the Congress. We have to deal with realities, and I think the political reality is that consumption tax or value-added tax are looked at as being regressive, even if you exempt food, drugs, and clothing. It has always been my view that the only way that you could have a chance of a snowball in the Sun, or better than that, chance of convincing the average worker in this country that that kind of a tax would be a good idea if it could be coupled in some way with some reduction in the requirement that people at the bottom end of the economic scale have to pay in Social Security tax.

So if you were to exempt, say, the first thousand dollars of income from payroll taxes, making that program less regressive, that you could then use that combination to perhaps persuade people that it would be a smart thing to do, it would be in their interest and be fair.

Any special reaction to that?

Mr. **Friedman**. I haven't heard that proposal before, but my initial reaction is favorable. I'd like to think about it before putting myself on the record with a specific response. I hadn't heard it before, but I find it a very interesting idea.

On the politics of the matter, Mr. Chairman, I might point out that a Harris poll done just a month ago had what I thought was a very surprising result. An unsurprising result is that there is no broad-based tax—that is, a tax that the average citizen expects he or she will have to pay personally—that commands majority support in the Nation. There is majority support, of course, for taxes that the average citizen doesn't think he or she would have to pay. Raising the corporation income tax gets a 3 to 1 majority. Raising the top-tax rate on people with incomes over $200,000 gets an overwhelming majority.

But, of the broad-based taxes that people clearly understand that they personally would have to pay, the majority disfavoring a national sales tax is only 50 to 47 percent. That was, by some distance, the smallest majority disfavoring any broad-based tax.

Representative **Obey**. But if you disaggregate that poll and take a look at people's response by income level, you would probably find an interesting split.

Mr. **Friedman**. That's no doubt right. For that reason I think the proposal that you offered a minute ago, to link the national sales tax, or value-added tax, with a specific concession at the bottom of the Social Security spectrum, is quite interesting. Then, to the extent that the 50 percent who are opposed are disproportionately located at the bottom of the scale, they, too, would feel that something had been done in their behalf.

Representative **Obey**. We might get as much support for it as we got for the congressional pay raise.

I know you have to leave, so let me thank you very much for coming. I do have a number of other questions that I'd like to get to you, but we may just ship a few up to you.

Mr. **Friedman**. I will be very happy to respond to anything you send me. Similarly, if it would be useful to you to meet privately sometime, I would be glad to do so.

Thank you for inviting me, Mr. Chairman.

Representative **Obey**. Thank you very much.

Mr. Litan, you have been sitting here patiently. Would you like to comment on any of the questions which I asked Mr. Friedman?

Mr. **Litan**. Well, let's try "king for a day." I agree with Ben Friedman that we should try to split the reduction, the budget deficit reduction half and half between expenditure cuts and tax increases. I know the political advantage of spreading the budget cuts as broad as possible, but nevertheless if I were king for a day, I think there are parts of the budget it would seem to me that deserve more hacking then others.

The one highest on my list would be agricultural subsidies that I would like to do in conjunction with some kind of negotiated trade agreements. Second on my list is to try to pursue some coordinated defense cuts, take Gorbachev seriously and try to get the defense budget down a little bit, and then spread the rest around.

Now, on the revenue side, frankly I'm of the view that almost any revenues from any source are desirable and I'm almost indifferent as to how you raise them. I think you're going to need them if you want to have serious budget deficit reduction.

But just to put alongside the VAT proposal another proposal, you know each point on income tax rates is worth about $30 billion. That's both corporate and personal. In other words, you would raise $60 billion with two extra points. That's not an Earth-shattering proposal after all. I mean, my goodness, the top marginal rate has come down from 70 to 28 percent. So two extra points doesn't sound like a lot.

However, for the reasons that we were talking about earlier, I would not, if I were king for a day, raise the bottom rate. I would take it out of the next two brackets and I would correct the notch in the Tax Code from the 33 percent rate declining to 28 percent for the high-income taxpayers. I would bring the high-income rate back up so that it's several points higher than the current middle rate at 33 percent.

So in other words, I could see two top steps of something like 35 and 38 percent. That's not the end of the world. We had 38 percent as the top rate just a couple of years ago. In fact, even last year when I did my tax return, 38 percent was the top bracket.

So I personally don't see anything wrong with just doing a sort of mid-course correction on the tax rates rather than introducing a whole vast new machinery for the VAT which, of course, the VAT would require. And so I would just put that alongside the other proposals.

Now, just one final word on the so-called tax increase. I'm sure, Mr. Chairman, you hear from many people that if we have a tax increase, that will kill the economy. People have to understand that if you have a tax increase and we have a smaller budget deficit, that allows Alan Greenspan to lower interest rates. And so all those people that may have to pay a little more in taxes are going to have declining interest costs, especially if they have adjustable rate mortgages or credit card costs. And so they have to be made to understand that there will be offsetting benefits to them even if they have a tax increase.

Representative OBEY. Mr. Niskanen had indicated that he believed that the Federal Reserve should not attempt to try to limit real growth of the economy to a target of about 2½ percent a year, and that higher growth wouldn't cause inflation.

Do you have any particular comment on that?

Mr. LITAN. Yes. I disagree with it.

Representative OBEY. Why?

Mr. LITAN. Because I believe most of the conventional forecasts that productivity growth, combined with population growth, is unlikely to increase out potential output growth path any faster than about 2½ percent a year, and we are about as close to reaching the noninflationary growth rate in our economy as we're going to reach. In fact, we've had 2 months of very disturbing inflation news, and so we're reasonably close to full employment, in quotes, in the sense that that unemployment rate is about all we can take without accelerating inflation.

And so for here on out, we ought to be growing at our potential growth path, and I don't think the 3 percent-plus growth path that's in the administration's forecast is realistic for potential growth, nor does Alan Greenspan, nor does the bulk of the economics profession. They think that 2½ is closer to the mark. And so I prefer not to risk inflation.

We all know what happens if we let inflation get out of control.

Representative OBEY. Do you have any view—you know the argument that's made that one of the pernicious effects of the Government cuts is that does have a reverse Robin Hood effect in that it benefits people who have money to lend and hurts people who don't, because everybody is paying for the deficit, but at least people who can lend money are benefiting from it to some degree.

Do you have any judgment as to how real that is as opposed to theoretical, how serious it is?

Mr. LITAN. What? The view that because we've have high real interest rates, lenders have done very well this decade and creditors haven't. Well, that's true for lenders and creditors. But they're often the same people.

A business is both a lender and a creditor in its activities. When it wants to expand, it's a borrower. And when it has excess cash around, it's a lender.

I would rather get away from this sort of divisive view of the world, lenders versus creditors, and think of all of us being in the same boat. And the fact is, if you look at it from that point of view, deficits are corrosive. They slow the rate of investment. They slow the rate of productivity growth.

Representative OBEY. You don't think that there is any siginificant upward movement of wealth because only a small number of families in this country actually have enough assets to be able to invest in those instruments?

Mr. LITAN. It's true that maybe a relatively small proportion of the American people buy Treasury bonds, but vast numbers of us have pension funds. And our pension funds buy these securities, and so we benefit in the form of pension holdings, and that's true for the vast majority of the American people.

Representative OBEY. You doubt that there is much of a redistribution aspect?

Mr. LITAN. That's right. I don't think the widening of the income disparties across groups in our society in the 1980's is driven by this. It's driven by tax factors, and it's driven, frankly, on the family level by the two-earner family trend, with more two-earner families. That is increasing the dispersion of income.

For instance, if you look at the percentage of income that has gone to families below $20,000 versus those between $20,000 and $50,000, and those at $50,000 and above, all in real dollars, then compared with 1973, you find out that the middle class has actually shrunk. The proportion of all our families in the middle has shrunk, but that is not because the proportion at the bottom has increased, it's because the proportion at the top has actually increased.

And the major reason why we have more people in the over $50,000 category is the two-earner family trend.

Representative OBEY. There are a number of questions I'd like to ask you, but we're out of time, so I thank you very much for being here today. The committee stands adjourned.

[Whereupon, at 12:25 p.m., the committee adjourned, subject to the call of the Chair.]

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